Supreme Court, U.S.
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No. _____

In the
SUPREME COURT OF THE UNITED STATES
October Term, 1996

PERRY S. McKAY, *Petitioner,*

v.

CHRISTINE J. JOBIN, Chapter 7 Trustee for the Estate of M & L Business Machine Co., Inc., *Respondent.*

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

PETITION FOR WRIT OF CERTIORARI

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125 pp

QUESTIONS PRESENTED FOR REVIEW

1. Whether §548(c) of the Bankruptcy Code, which provides a defense for a "good faith" transferee in a trustee's action to recover fraudulent conveyances, protects investors in a Ponzi scheme who are "fraudulently induced to invest in [the scheme,]" and who do "not have actual knowledge of the fraud" (*i.e.*, the "subjective" standard of good faith), even though a reasonable person engaging in a diligent inquiry might have been able to discover the fraud (i.e., the "objective" standard of good faith).

2. Whether §547(c)(2) of the Bankruptcy Code, which provides a defense to creditors for preferential payments that are made by the debtor in the "ordinary course of business or financial affairs," applies when the debtor's business or financial affairs is the operation of a Ponzi scheme and when it has made interest payments to investors.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Perry S. McKay ("Petitioner") respectfully prays that a writ of certiorari issue to review the May 29, 1996 opinion of the United States Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit is reported at 84 F.3d 1330 (App. 69). The opinion of the United States District Court for the District of Colorado is reported at 164 B.R. 657 (App. 46). The opinion of the United States Bankruptcy Court concerning the parties' cross motions for summary judgment is reported at 155 B.R. 531 (App. 1). The Bankruptcy Court's June 10, 1993 opinion following trial was unreported (App. 25).

JURISDICTION

On May 29, 1996, the United States Court of Appeals for the Tenth Circuit affirmed the judgment of the United States District Court. *Jobin v. McKay (In re M & L Business Machine Co., Inc.)*, 84 F.3d 1330 (CA10 1996) (App. 69). On June 6, 1996, Petitioner filed a timely Petition for Rehearing which the Tenth Circuit denied on July 16, 1996 (App.96). The jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254(1).

STATUTES INVOLVED IN THIS CASE

A. 11 U.S.C. §548(c):

> Except to the extent that a transfer or obligation voidable under this section [11 U.S.C. §548] is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

B. 11 U.S.C. §547(c)(2):

> (c) The trustee may not avoid under this section [11 U.S.C. §547(b)] a transfer –
>
> * * *
>
> (2) to the extent such transfer was –
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms[.]

STATEMENT OF THE CASE

This case involves the construction and application of the United States Bankruptcy Code, specifically §547 (preferences) and §548 (fraudulent transfers), where the debtor is a Ponzi scheme, as opposed to a legitimate enterprise. The Ponzi scheme's bankruptcy trustee sued hundreds of investors who had been duped into loaning money to the enterprise and who lost money in the fraud.

Based upon the recommendation of a long time acquaintance who was an economics professor, as well as what were purported to be audited financial statements, Perry S. McKay (Petitioner) invested a total of $207,500 with a company known as M & L Business Machine Co., Inc. (M & L). Generally, the terms of the investments required M & L to pay Petitioner 10% per month for a period of 24 months and, at the end of that term, return his principal. M & L issued promissory notes to Petitioner along with a series of post-dated checks to coincide with the monthly installments of interest. The monthly interest checks could be negotiated after the date on the check arrived.

On October 1, 1990, about three and one-half months after Petitioner began investing, M & L filed a voluntary petition under Chapter 7 of the Bankruptcy Code. Petitioner had received $43,500 in monthly interest checks as of the date of the bankruptcy filing. As a consequence, Petitioner had incurred a net loss in the amount of $164,000 from his investments with M & L ($207,500 invested less $43,500 received).

On December 18, 1990, Christine J. Jobin (Respondent) was appointed as M & L's bankruptcy trustee. After her investigation, Respondent concluded that M & L was a Ponzi scheme. That is, she surmised that M & L repaid its earlier investors with funds received from later investors, rather than with profits or revenues generated from the operation of a legitimate business. At least 1,695 individuals (including attorneys, doctors, accountants, and stockbrokers), as well as two financial institutions, had collectively loaned M & L tens of millions of dollars (Aplt.App. 346; Petitioner's Exh. 11; Respondent's Exh. P).

Respondent thereafter commenced over 400 separate adversary proceedings against investors in the Ponzi scheme

who had received payments from M & L under their respective investment contracts. Without regard to whether an investor made a profit or a loss from the Ponzi scheme, Respondent alleged that M & L's payments were voidable as preferences (11 U.S.C. §547), fraudulent transfers (11 U.S.C. §548), and, in some instances, unauthorized post-petition transfers (11 U.S.C. §549). Respondent sought to recover millions of dollars collectively from the persons defrauded by M & L.[1]

Specific to the instant case, on September 30, 1992, Respondent filed a Complaint seeking to void and recover the $43,500 which Petitioner had received. The Bankruptcy Court had jurisdiction over that proceeding pursuant to 28 U.S.C. §1334(b), 28 U.S.C. §157(a), and the United States District Court's General Procedure Order No. 1984-3 (automatically referring proceedings to the Bankruptcy Court). The adversary proceeding constituted a "core proceeding." 28 U.S.C. §157(b)(2)(F) and (H).

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1. Of the 400 lawsuits, this case was the first one that went to trial. The M & L case has since erupted into a myriad of rulings on varying issues. *E.g., Jobin v. Boryla,* 75 F.3d 586 (CA10 1996); *Jobin v. Youth Benefits Unlimited, Inc.,* 59 F.3d 1078 (CA10 1995); *Jobin v. Ripley,* 198 B.R. 800 (D. Colo. 1996); *Jobin v. Cervenka,* 194 B.R. 496 (D.Colo. 1996); *Jobin v. Otis,* 190 B.R. 111 (D.Colo. 1995); *Jobin v. Matthews,* 184 B.R. 136 (D.Colo. 1995); *Jobin v. Kloepfer,* 159 B.R. 932 (D.Colo. 1993) and 184 B.R. 366 (D.Colo. 1995); *Jobin v. Harper,* 181 B.R. 530 (D.Colo. 1995); *Jobin v. Bank of Boulder,* 169 B.R. 711 (D.Colo. 1994) and 170 B.R. 169 (D.Colo. 1994); *Jobin v. Lalan,* 160 B.R. 851 (Bankr.D.Colo. 1993), *aff'd,* 167 B.R. 219 (D.Colo. 1994); *Jobin v. Waukau,* 166 B.R. 723 (Bankr.D.Colo. 1993); *Amazing Enterprises, et al. v. Jobin,* 136 B.R. 271 (Bankr.D.Colo. 1992), *aff'd,* 160 B.R. 850 (D.Colo. 1993); *Jobin v. Resolution Trust Corp.,* 156 B.R. 834 (D.Colo. 1993) and 160 B.R. 161 (D.Colo. 1993); *Jobin v. Baker & Hostetler,* 153 B.R. 312 (D.Colo. 1993).

Despite the fact that Petitioner lost $164,000 of the $207,500 he invested in the Ponzi scheme, Respondent claimed that the $43,500 which he had received was voidable as a preference, fraudulent transfer, and, with respect to the final interest check which cleared M & L's bank on the same date as the bankruptcy filing, an unauthorized post-petition transfer.

Prior to trial, the Bankruptcy Court entered summary judgment against Petitioner on the Respondent's preference and post-petition claims in the amount of $22,000. *Jobin v. McKay (In re M & L Business Machine Co., Inc.)*, 155 B.R. 531 (Bankr.D.Colo. 1993) (App. 1-24) It opined that, as a matter of law, the Ponzi scheme's payments to Petitioner could not qualify for the "ordinary course of business" defense under §547(c)(2).[2]

In addition, the Bankruptcy Court ruled that because M & L was a Ponzi scheme, payments to investors were made with the intent to defraud future investors. Accordingly, the Bankruptcy Court granted summary judgment to Respondent with respect to her claim under §548(a)(1) (transfer made by the debtor with actual intent to hinder, delay, or defraud creditors is voidable) (App. 17-18). This judgment was subject to Petitioner's §548(c) defense (transferee that takes for "value" and in "good faith" may retain transfer), which the Bankruptcy Court concluded presented factual questions (App. 21, n. 22).

Following trial, the Bankruptcy Court found that Petitioner had given "value" to M & L in exchange for the $43,500 he had received. This "value" consisted of a dollar-for-dollar satisfaction of M & L's obligation to make restitution to

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2. The Bankruptcy Court allowed Petitioner to offset the $43,500 in preferences with $21,500 of subsequent "new value" under 11 U.S.C. §547(c)(4) (App. 13-17). Thus, judgment on the preference claim was limited to $22,000.

Petitioner. *See* 11 U.S.C. §548(d)(2)(A) (defining "value" under §548 as including the satisfaction of a debt of the debtor) (App. 37-39).

However, for purposes of determining a transferee's "good faith" under 11 U.S.C. §548(c), the Bankruptcy Court adopted the objective "reasonable person" standard, rather than a rule requiring inquiry into the transferee's actual state of mind (*i.e.*, the subjective standard) (App. 39-44). Although finding that Petitioner did not have actual knowledge that M & L was a fraud (and indeed finding that he had a restitution claim against M & L as a consequence of being defrauded), the Bankruptcy Court concluded that under the objective standard Petitioner lacked "good faith" (App. 39-44). It therefore entered judgment against him for $43,500 (the total amount of all M & L interest checks which he cashed).[3]

On June 16, 1993, Petitioner filed a timely Notice of Appeal to the United States District Court for the District of Colorado. Fed.R.Bankr.P. 8002. The United States District Court had jurisdiction over that appeal, 28 U.S.C. §158(a), and on February 9, 1994, it affirmed. *See Jobin v. McKay (In re M & L Business Machine Co., Inc.)*, 164 B.R. 657 (D. Colo. 1994) (App. 46-68). On February 11, 1994, Petitioner filed a Notice of Appeal to the United States Court of Appeals for the Tenth Circuit. The Tenth Circuit had appellate jurisdiction pursuant to 28 U.S.C. §158(d).

On May 29, 1996, the Court of Appeals rendered a decision. *See Jobin v. McKay (In re M & L Business Machine Co., Inc.)*, 84 F.3d 1330 (CA10 1996) (App. 69-95). While acknowledging that Petitioner "was fraudulently induced to invest in M & L" (App.

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3. The $43,500 judgment for fraudulent transfers included the $22,000 which were previously voided as preferences.

94), that "he did not have actual knowledge of [M & L's] fraud" (App. 94), and that, as a consequence, he held a claim for restitution against M & L for his $164,000 loss (App. 90-94), the Tenth Circuit ruled that "good faith under §548(c) is measured objectively." *McKay*, 84 F.3d at 1338 (App. 85). It held that "if the circumstances would place a *reasonable person* on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." *McKay*, 84 F.3d at 1338 (emphasis supplied in part) (App. 85).

Separately, the Tenth Circuit also rejected Petitioner's "ordinary course of business" defense to the Respondent's preference claim. The panel held that "because investment companies do not ordinarily pay fraudulent profits to early investors, the §547(c)(2) defense is inapplicable to payments to investors in a Ponzi scheme." *McKay*, 84 F.3d at 1339-1340 (App. 89). Judgment against Petitioner for $43,500 was accordingly affirmed.

REASONS FOR GRANTING THE PETITION

Justice Kennedy has observed that "Ponzi schemes . . . can maintain the illusion of a profit-making enterprise for years, and sophisticated investors may not be able to discover the fraud until long after its perpetration." *Lampf, Pleva, Lipkind, Prupis & Petigrew, v. Gilbertson*, 501 U.S. 350, 377, 11 S.Ct. 2773, 115 L.Ed.2d 321, 345 (1991) (Kennedy J., dissenting). This comment, although made in the context of §10(b) of the Securities and Exchange Act, is the very essence of this case, *i.e.*, whether such investors, who acted honestly, who did not actually know about or discover the fraud, and who lost money overall in the scheme, should be liable for the payments they received before the collapse of the enterprise.

I. THE QUESTIONS PRESENTED ARE IMPORTANT

A. THE *McKAY* OPINION WILL AFFECT EVERY OTHER PONZI SCHEME BANKRUPTCY CASE TO HARM INNOCENT AND UNWARY INVESTORS

"[W]hile Charles Ponzi has been dead for a half-century, his legacy, the Ponzi scheme, lives on in the investment world. In fact, it just might be more prevalent than ever in the U.S." "Ponzi Lives!" *Barron's*, Vol. LXXVI No. 38, p. 16, (September 16, 1996).[4] Aside from the hundreds of adversary proceedings brought by Respondent in M&L's bankruptcy case, other Ponzi scheme bankruptcy trustees are already beginning to employ *McKay* as a sword against honest people who were defrauded out of their savings.

Recently, in another ongoing Ponzi scheme bankruptcy case, *Raejean Bonham a/k/a Jean Bonham a/k/a Jeannie Bonham d/b/a World Plus*, U.S. Bankruptcy Court for the District of Alaska, Case No. F95- 00897 HAR, the trustee's counsel has advised that they are now beginning the process of suing investors (including those that lost money in the fraud) to recover

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4. Some of the more recent Ponzi scheme cases include, *e.g.*, *Scholes v. Lehmann*, 56 F.3d 750 (CA7 1995); *Sender v. Heggland Family Trust (In re Hedged Investments Associates, Inc.)*, 48 F.3d 470 (CA10 1995); *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589 (CA9 1991); *Wooten v. Barge (In the Matter of Cohen)*, 875 F.2d 508 (CA5 1989); *Emerson v. Marty (In re Mark Benskin & Co., Inc.)*, 135 B.R. 825 (Bankr.W.D.Tenn. 1991), *aff'd mem.*, 59 F.3d 170 (CA6 1995); *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843 (D.Utah 1987); *DiCello v. Jenkins (In re International Loan Network, Inc.*, 160 B.R. 1 (Bankr.D.Dist.Col. 1993); *In re Taubman*, 160 B.R. 964 (Bankr.S.D. Ohio 1993).

fraudulent transfers and preferences. The trustee there has already filed 74 suits against the Ponzi scheme's investors seeking to avoid and recover over $2.5 million. The trustee's counsel has stated that they intend to file at least 150 more adversary proceedings in the *World Plus* case.

In addition, an entity known as the *Foundation for New Era Philanthropy* has recently filed bankruptcy in Pennsylvania. U.S. Bankruptcy Court Eastern District of Pennsylvania, Case No. 95-13729BIF. Like M & L, the *New Era Philanthropy* was discovered to be a Ponzi scheme, and sophisticated investors, such as the former Secretary of Treasury and the former co-chair of Goldman Sachs, had invested considerable sums in that enterprise. The trustee there has alleged hundreds of fraudulent transfers and preferences, including $150 million to Prudential Securities, Inc. because, according to the trustee, Prudential objectively "should have known" of the fraud even if it did not have actual subjective knowledge.

The holding in the *McKay* case translates into millions of dollars of liability to investors in Ponzi schemes who act honestly and who do not actually know about or discover the debtor's fraud. In several cases, the holding in *McKay* resulted in an investor's liability for many times more than he or she had even invested in the debtor's enterprise. *See, e.g., Jobin v. Cervenka,* 194 B.R. 496 (D.Colo. 1996) (where the investor initially invested $130,000, deposited his M & L checks every month when they came due and simultaneously wrote M & L a new check to "rollover" his investment for another month, investor held liable for $670,000 - the total amount of all M & L checks he deposited - even though his net gain was merely $5,425); *Jobin v. Ripley,* 198 B.R. 800 (D.Colo. 1996) (following Tenth Circuit's holding in *McKay* and finding the investor liable for over $1.3 million where the investor was simply reinvesting

his M & L payments); *Jobin v. Lalan*, 160 B.R. 851 (Bankr.D.Colo. 1993), *aff'd*, 167 B.R. 219 (D.Colo. 1994) (utilizing an "objective" standard of "reasonableness" and holding investor liable for over $409,000); *Jobin v. McFadden*, Adv.Proc.No. 92-2785 RJB (Aplee.Supp.App. at 59-60) (agreeing with *McKay* and adopting the objective standard of good faith).

The interpretation given by the Tenth Circuit in this case to §§547 and 548 of the Bankruptcy Code effectively perpetuates the Ponzi scheme. A bankruptcy trustee will typically only be able to recover payments made by the Ponzi scheme to later investors (such as Petitioner) because only payments made within the last ninety days are considered preferential, 11 U.S.C. §547(b)(4)(A), and only payments made within the last year are fraudulent under §548. 11 U.S.C. §548(a).

As a result, the bankruptcy trustee will end up distributing the funds recovered from later investors (those who typically lose the most money in a Ponzi scheme) to pay earlier investors - those outside the reach of the trustee's avoidance powers - while at the same time taking a fee for her services. By definition, that is a Ponzi scheme. *See, e.g., Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 871 (D.Utah 1987) (noting that because §547 does not reach the early investors in a Ponzi scheme, "applying the statute as written, the court is compelled to take part in a farce whose result is . . . to take away from those who have little, the little that they have.").

B. UNIFORMITY BETWEEN BANKRUPTCY CODE AND STATE FRAUDULENT CONVEYANCE LAWS

A decision in this case will not only provide consistency in the application of §548(c) of the Bankruptcy Code, particularly to investors caught within a Ponzi scheme's web of deception, it will also harmonize federal fraudulent transfer law with analogous state law. Following the enactment of the

Bankruptcy Code in 1978, the National Conference of Commissioners on Uniform State Laws replaced the Uniform Fraudulent Conveyance Act (UFCA) with the Uniform Fraudulent Transfer Act (UFTA). The change was made to track the language of the Bankruptcy Code, and to make the laws concerning fraudulent transfers uniform across the nation. *See* UFTA (Prefatory Note), 7A U.L.A. 639 (1984); UFTA §11 (1984).

In particular, the UFTA, which has been adopted in Colorado and 32 other states, like §548(c) of the Bankruptcy Code and virtually every other fraudulent conveyance law, insulates "good faith" transferees from fraudulent conveyance claims. *See* UFTA §8(d), 7A U.L.A. 643, 662 (1984) and Official Comment 4 (UFTA §8(d) "is an adaptation of §548(c) of the Bankruptcy Code."). Consistent interpretation of state fraudulent conveyance law with the Bankruptcy Code is essential to promote commerce nationally. *Moody v. Security Pacific Business Credit*, 971 F.2d 1056 (CA3 1992).

Moreover, in the bankruptcy context, "courts have varied widely in the general approach they have taken in deciding questions of good faith in the context of fraudulent conveyance law." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557 (Bankr.D. Ill. 1994), *citing*, 4 *Collier on Bankruptcy*, para. 548.07[2] at 548-71 (Lawrence P. King et al. eds. 15th ed. 1993). This case presents the Court with an opportunity to settle this widespread disagreement and to determine the proper construction of §548(c). *See Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) (certiorari granted to determine proper construction of 11 U.S.C. §554).

C. CONGRESS ENACTED §547(c)(2) AFTER THE SUPREME COURT DECIDED THE ORIGINAL PONZI SCHEME CASE

Since former Chief Justice Taft first authored the original Ponzi scheme case over 70 years ago, *see Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L. Ed. 873 (1924), the Bankruptcy Code has been overhauled, including Congress' addition of the "ordinary course of business" defense.

Although the Supreme Court in *Cunningham v. Brown, supra*, (a case reviewed on writ of certiorari), determined that Ponzi's investors were "creditors" and that the payments they received were preferences, "[t]he text of the preference provision in the earlier Bankruptcy Act did not specifically include an exception for payments made in the ordinary course of business." *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). In 1978, "Congress created a new exception for transfers made in the ordinary course of business." *Union Bank, supra.* It is now ripe for the Court to test the vitality of *Cunningham v. Brown, supra*, in light of Congress' enactment of §547(c)(2).

D. THE QUESTION WAS RECENTLY LEFT UNRESOLVED BY THE SUPREME COURT

In *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991), the Supreme Court granted certiorari to review the proper application of the "ordinary course of business" exception. Although not stated in the Supreme Court's opinion, the preferential payments there were made by a *Ponzi* scheme. *See In re ZZZZ Best Co., Inc.*, 921 F.2d 968 (CA9 1990) (bankruptcy court and district court allowed §547(c)(2) defense). While narrowly holding that the ordinary course of business exception was applicable to payments on both long term and short term debt, the Supreme Court remarked that it

was *not expressing* an opinion on whether the bankruptcy court had correctly found the debtor's payments were made within the ordinary course of business and according to ordinary business terms. *Union Bank*, 502 U.S. at 162, 112 S.Ct. at 533-534, 116 L.Ed.2d at 525.

Despite the Supreme Court's language that it was not expressing an opinion, one district court has since interpreted *Union Bank* as implicitly overruling earlier Ninth Circuit precedent which had held that payments made by a Ponzi scheme could not be within the "ordinary course of business." *American Continental Corp. v. All Preference Defendants (In re American Continental Corp.)*, 142 B.R. 894 (D.Ariz. 1992) (2,000 defrauded investors were entitled to the protection of §547(c)(2)); *cf. Danning v. Bozek (In re Bullion Reserve Of North America)*, 836 F.2d 1214 (CA9 1987), *cert. denied*, 486 U.S. 1056, 108 S.Ct. 2824, 100 L.Ed.2d 925 (1988).

Because Ponzi schemes will unfortunately endure, this Court should decide the broader issue which was expressly left unanswered by *Union Bank*, to wit, whether payments made by a Ponzi scheme can be within the "ordinary course of business or financial affairs." *See generally, American Textile Manufacturers Institute, Inc. v. Donovan*, 452 U.S. 490, 101 S.Ct. 2478, 69 L.Ed.2d 185 (1981) (certiorari granted to resolve important question presented by, but not decided in, a prior Supreme Court case).

II. THE TENTH CIRCUIT'S DECISION CONFLICTS IN PRINCIPLE WITH OTHER COURTS

The Tenth Circuit's opinion permits a bankruptcy trustee to recover fraudulent transfers from a defrauded investor in a Ponzi scheme who had a *net loss*. Other circuit and lower courts confronted with this issue limit recovery against those

investors in a Ponzi scheme who made a *profit* at the expense of the other investors. Recovery in such cases is, logically, limited to the amount of the "profit" received by the investor. *See, e.g., Scholes v. Lehmann*, 56 F.3d 750, 757-759 (CA7 1995) (in Ponzi scheme, receiver could recover investor's profit as fraudulent transfer); *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 595-596, n.6 (CA9 1991) (Chapter 7 trustee could not avoid fraudulent transfers made to investors in Ponzi scheme where investors acting without "culpable knowledge" did not receive more from the debtor than the amount of their investments); *Eby v. Ashley*, 1 F.2d 971, 973 (CA4 1924), *cert. denied*, 266 U.S. 631, 45 S.Ct. 197, 69 L.Ed. 478 (1925) (amounts paid in excess of principal in Ponzi scheme are fraudulent); *DiCello v. Jenkins (In re International Loan Network, Inc.)*, 160 B.R. 1 (Bankr.D.C. 1993) (bankruptcy trustee may recover fraudulent transfers made by Ponzi scheme to investors over and above the amount of the investor's individual investment); *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 861 (D.Utah 1987) (bankruptcy trustee may recover fraudulent transfers made by Ponzi scheme to investors who received an excess over their investments).

Outside of the Ponzi scheme context, the Fourth Circuit held in a pre-Code case that the recipient of a fraudulent transfer does not lack good faith "unless the transferee knowingly participated in the debtor-transferor's purpose to defeat other creditors." *Gilmer v. Woodson*, 332 F.2d 541, 547 (CA4 1964), *cert. denied*, 379 U.S. 834, 85 S.Ct. 67, 13 L.Ed.2d 42 (1964). Bankruptcy courts within the Fourth Circuit have since embraced *Gilmer's* standard of "good faith" for purposes of §548(c). *See Practical Investment Corp. v. Rellen (In re Practical Investment Corp.)*, 95 B.R. 935, 944 (Bankr.E.D. Va. 1989) (good faith under §548(c) demonstrated where the transferee "did not

have *actual knowledge* of [the transferor's] fraud in the transaction, [and] did not *knowingly participate* in [the transferor's] purpose to defeat his creditors.").

Pre-Code decisions from the Seventh Circuit also held that the test is what the transferee actually and consciously realized. *See Security Discount Co. v. Wesner (In re Peoria Braumeister Co.)*, 138 F.2d 520 (CA7 1943); *In re Soudan Manufacturing Co.*, 113 F. 804 (CA7 1902). Like the lower courts in the Fourth Circuit, the bankruptcy courts within the Seventh Circuit have found that these pre-Code cases were controlling for purposes of interpreting the phrase "good faith" under 11 U.S.C. §548(c). *In re Telesphere Communications, Inc.*, 179 B.R. 544, 558-559 (Bankr.N.D.Ill. 1994) (concluding that although the creditors may have been negligent in their due diligence, "a grantee in a fraudulent conveyance who is not guilty of actual fraud, but is chargeable with knowledge of such facts that the law holds him guilty of constructive fraud is entitled to protection . . . .").

III. THE TENTH CIRCUIT'S DECISION IS ERRONEOUS

A. 11 U.S.C. §548(c):

Section 548(c) protects the recipient of a fraudulent transfer who "takes for value and in good faith...." Congress defined "value" under §548 as including the "satisfaction . . . of a present or antecedent debt of the debtor . . . ." 11 U.S.C. §548(d)(2)(A).[5] However, Congress did not define the phrase

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5. A Ponzi scheme's payment to an investor satisfies or reduces the debt it owes to make restitution to the defrauded investor. *See, e.g., Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 595-596 (CA9 1991); *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 857 (D.Utah 1987). As such, "value" is given by the investor for the Ponzi scheme's transfer.

"good faith," and the "legislative history related to Section 548(c) never defines and scarcely addresses good faith." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557, n. 20 (Bankr.N.D.Ill. 1994).

Section 548 was "derived in large part from section 67d of the Bankruptcy Act." H.Rept. No. 95-595 to accompany H.R. 8200, 95th Cong., 1st Sess. p. 375 (1977). Section 67(d)(6) of the Bankruptcy Act in turn protected transferees who acted "without actual fraudulent intent." Hence, when Congress rewrote the bankruptcy laws in 1978, it simply changed the phrase "without actual fraudulent intent" to "good faith." Congress did not provide any explanation as to why it was making this change.

"When Congress amends the bankruptcy laws, it does not write `on a clean slate.'" *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992). Courts should therefore be "reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup, supra.* Pre-Code practice measured a transferee's "good faith" by applying the subjective standard. *See, e.g., Gilmer v. Woodson*, 332 F.2d 541, 547 (CA4 1964), *cert. denied*, 379 U.S. 834, 85 S.Ct. 67, 13 L.Ed.2d 42 (1964).

From a pure policy perspective, an innocent investor in a Ponzi scheme who has already lost money in the scheme and who acts honestly (even if negligently) should not be liable for the portion of the funds he or she was fortunate enough to have received. *American Continental Corp. v. All Preference Defendants (In re American Continental Corp.)*, 142 B.R. 894, 900 (D.Ariz. 1992) (in a Ponzi scheme, "[a]lthough it is inequitable for certain creditors to retain their payments, while others go

unpaid, it is far more inequitable to penalize those who were paid, for an alleged fraud that was not of their doing, and by which they may have already been substantially damaged.").

In addition to the Tenth Circuit's disregard of pre-Code practice, it also stated that it was "not persuaded by [Petitioner's] argument that the definitions of good faith under . . . state fraudulent conveyance laws should be adopted in interpreting §548(c)." *McKay*, 84 F.3d at 1338 (App. 84). The Supreme Court, however, has recently instructed that, unless the federal statutory purpose is clear and manifest, §548 of the Bankruptcy Code must be construed to adopt, rather than to displace, pre-existing state law. *See BFP v. Resolution Trust Corp.*, 511 U.S. ___, 114 S.Ct. 1757, 128 L.Ed.2d 556, 569 (1994).[6]

Like the former Bankruptcy Act, the UFCA protected transferees who acted "without knowledge of the fraud." UFCA §9; *Smith v. Whitman*, 39 N.J. 397, 189 A.2d 15, 20 (1963) (under the UFCA, good faith is lacking only if the transferee *aids* the debtor in the debtor's purpose to secrete assets or *joins in the plan* designed to hinder creditors); *Territorial Savings and Loan Ass'n v. Baird*, 781 P.2d 452, 461 (Utah. App. 1989) ("In the context of fraudulent conveyances, other courts considering whether a conveyance was made in good faith have examined the *subjective* beliefs and intentions of the transferee concerning the propriety of the activities and their *knowledge* that the result would take unconscionable advantage of others."); Comment,

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6. Without analysis or explanation, the Tenth Circuit concluded that state fraudulent conveyance law involves "policy concerns not applicable here." *McKay*, 84 F.3d at 1338 (App. 84). The policies underpinning state fraudulent conveyance law are the same as under bankruptcy law. Both laws serve to "undo" transfers wrongfully made by debtors for the benefit of a creditor or creditors.

Good Faith and Fraudulent Conveyances, 97 Harv.L.Rev. 495 (1983).

Creating a bankruptcy standard different from that found under state law, particularly the UFCA and UFTA, creates doubt, uncertainty, and conflicting results. Specific to Ponzi scheme cases, courts confronted with the question under state law receiverships have held that the defrauded investor, who acts without knowledge of the fraud, is not liable for receiving fraudulent transfers unless he or she made a "profit." *See, e.g., Scholes v. Lehmann*, 56 F.3d 750 (CA7 1995); *Johnson v. Studholme*, 619 F. Supp. 1347 (D.Colo. 1985), *aff'd, Johnson v. Hendricks*, 833 F.2d 908 (CA10 1987). There is no principled basis for holding investors who were victimized by a Ponzi scheme liable to a bankruptcy trustee, when the same investor would not be liable if a state court receiver, performing the same function as a trustee, had been appointed.

B. 11 U.S.C. §547(c)(2):

Section 547 is intended to discourage a race to the courthouse and to promote the equal treatment of creditors. *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). However, not all transfers by a debtor on the eve of bankruptcy threaten to set off a race to the courthouse or to undermine the equal treatment of creditors. Payments made in the "ordinary course of business or financial affairs" are of this type.

By enacting §547(c)(2) (the "ordinary course of business" defense), Congress meant to "leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991), *quoting*, H.R. Rep. No. 95-

595, at 373 (1977). Section 547(c)(2) applies to transfers made by the debtor *either* in the ordinary course of business *or* its financial affairs, suggesting that the exception applies even where the debtor is not a "business."

When the debtor is a Ponzi scheme, its "business" or "financial affairs" is to solicit money from investors and to pay earlier investors according to the terms of the investment contracts, in order to attract new investors. If the preferential payment to an investor is no different than the payments made to other investors, or according to terms inconsistent with the terms given to other investors, there is no race to the courthouse. In fact, the race to the courthouse would start sooner if the Ponzi scheme did not make its payments. *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 874 (D.Utah 1987).

Unlike the investors in the original Ponzi scheme case who learned from a widely circulated newspaper of Ponzi's insolvency and went into a "wild scramble" and a "race" to Ponzi's bank, *see Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924), here M & L interest checks, which corresponded with promissory notes providing a fixed rate of return, were merely cashed after the date on the post-dated check had passed. Thus, unlike *Cunningham*, there was no acceleration of the debt or "unusual action" taken by the investors to compel "preferential" treatment.

As far as the policy of promoting equal treatment of creditors, denying later investors of the §547(c)(2) defense treats those investors who received payments outside of the ninety day preference period more favorably and at the expense of later investors who lost all or most of their investment. *Merrill v. Abbott (In re Independent Clearing House*

Co.), 77 B.R. 843, 875 (D.Utah 1987). "Congress may not have intended to protect one group of investors over the rest, but neither did it intend to make one group bear a disproportionate share of the loss." *Id.*

CONCLUSION

This case is of national importance. Ponzi schemes have been discovered in virtually every jurisdiction, and bankruptcy trustees are perpetuating the damage to honest people who were lured into the fraud through the debtor's promise of large returns. Congress surely did not intend to subject honest people, who lost all or most of their savings from the debtor's fraud, to further liability under the Bankruptcy Code. For the preceding reasons, Petitioner respectfully requests this Court to grant the within Petition for a Writ of Certiorari.

DATED this 9th day of October, 1996.

Respectfully submitted,
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Counsel for Petitioner

No. _____

In the
SUPREME COURT OF THE UNITED STATES
October Term, 1996

PERRY S. McKAY, *Petitioner,*

v.

CHRISTINE J. JOBIN, Chapter 7 Trustee for the Estate of M & L Business Machine Co., Inc., *Respondent.*

On Petition for Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

CERTIFICATE OF SERVICE

I, Craig A. Weinberg, a member of the Bar of this Court, hereby certify that on the 9th day of October 1996, three copies of the Petition for Writ of Certiorari in the above-entitled case were mailed, first class postage prepaid, to Christine J. Jobin, The Jobin Law Firm, P.C., 475 17th Street, Suite 1390, Denver, Colorado 80202, counsel for the Respondent herein. All parties required to be served have been served.

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(303) 443-6690
Counsel for Petitioner

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
M & L BUSINESS MACHINE	)	Bankruptcy Case No.
COMPANY, INC.,	)	90-15491-CEM
Debtor.	)	
	)	
CHRISTINE J. JOBIN,	)	
Trustee of the Estate of	)	
M & L Business Machine	)	
Co., Inc.,	)	
Plaintiff,	)	
	)	
v.	)	
	)	Adversary
PERRY S. MCKAY,	)	Proceeding No.
Defendant.	)	92-2199-SBB

AMENDED MEMORANDUM OPINION AND ORDER ON MOTIONS FOR SUMMARY JUDGEMENT[1]

SIDNEY B. BROOKS, Bankruptcy Judge

THIS MATTER comes before the Court on (1) Defendant's Motion for Summary Judgment with Accompanying Brief filed December 4, 1992, Supplemental Authority in Support thereof filed January 5, 1993, Second Supplemental Authority in Support thereof filed January 25, 1993; (2) Memorandum Brief in Opposition to Defendant's Motion for Summary Judgment,

1. This Amended Order has been issued to correct three minor spelling and grammatical errors.

Cross-Motion for Summary Judgment by Plaintiff and Brief in Support Thereof filed February 8, 1993; (3) Defendant's Reply to Trustee's Response RE: Defendant's Motion for Summary Judgment filed March 15, 1993; and (4) Trustee's Supplemental Response to Defendant's Motion for Summary Judgment filed March 30, 1993. The Court, having reviewed the file and being duly advised in the premises, enters the following Memorandum Opinion and Order.[2]

I. FACTUAL BACKGROUND.

Debtor filed a Voluntary Petition pursuant to Chapter 7 of the Bankruptcy Code on October 1, 1990. The case was converted to Chapter 11 shortly thereafter. Christine J. Jobin ("Jobin" or "Trustee") was appointed Chapter 11 Trustee on December 18, 1990. The Court entered an Order on September 26, 1991 re-converting the case to Chapter 7. Jobin was appointed Chapter 7 Trustee on October 1, 1991. The Trustee presently has pending in this District over 400 adversary proceedings to avoid transfers and recover property of the estate. The within proceeding is just one of these actions.

Since its inception in the 1970's, Debtor operated a business and office machine repair business. This business continued to be operated until March 1991, when the Trustee shut it down.

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2. The various arguments presented by the parties in the myriad summary judgment pleadings and briefs before this Court are not parallel, or they do not otherwise track with each other; they are somewhat jerry-built and sometimes not responsive or coordinate with one another. This causes considerable confusion. A significant portion of this Court's time was needed to sort out and align the parties' respective positions.

Sometime during the early 1980's, Robert G. Joseph ("Joseph"), Daniel F. Hatch ("Hatch"), and David D. Parrish ("Parrish") acquired the stock of Debtor. In 1987, Joseph, Hatch and Parrish began operating a classic pyramid or Ponzi[3] scheme concurrently with the continuing, albeit diminished, legitimate business. They began soliciting and taking in money from over 1,000 third-party "Private Lenders" or "Private Investors" who were promised exceptionally high rates of return[4] for the use of their money ostensibly to buy large quantities of expensive computers and other office equipment. The "Private Investors" were told they would share in substantial profits upon the resale of computers and office equipment which were, in fact, never purchased.

The Trustee subsequently discovered that over 700 boxes, purported to have contained computer equipment, held various combinations of bricks, dirt, or hardened foam. When the scheme collapsed, approximately $83,000,000.00 in postdated, unpaid checks remained in the hands of various "Private Investors," even though over $74,000,000.00 flowed through Debtor's bank accounts from January 1990 through September 1990.

The Trustee filed the instant Complaint on September 30, 1992, seeking to avoid transfers and recover $43,500.00 paid

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3. *See, Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924) (the "original" Ponzi scheme).

4. During 1990, a typical transaction consisted of a $100,000.00 loan to Debtor for a two-week period with the promise of a 12% return, or an annual interest rate of approximately 312%. At the time they gave their money, the "Private Investors" received a series of post-dated checks and/or promissory notes.

Defendant within 90 days of the Petition, including one $4,000.00 check which cleared the Bank of Boulder on the date that the Petition was filed. The Defendant moved for summary judgment on several grounds. The Trustee filed a cross-motion for summary judgment. This Court has dealt simultaneously with both motions herein.

Briefly, this Court finds for the Trustee on her First (§ 547(b)), Second (§ 548(a)(1)), and Fourth (§ 549) Claims. This Court finds for the Defendant, in part, on his "new value" defense as an exception to preference transfers (11 U.S.C. § 547(c)(4)). Inasmuch as material factual issues remain with regard to the Trustee's Third Claim (§ 548(a)(2)) and Defendant's Affirmative Defense of "Good Faith" embodied in Section 548(c), summary judgment cannot be granted on that claim.

II. LEGAL ANALYSIS.

A. *Summary Judgment Standards.*

Summary judgment is a drastic remedy and may be granted only where there is no genuine issue of material fact and where the movant is entitled to judgment as a matter of law. *Carey v. U.S. Postal Service*, 812 F.2d 621 (10th Cir. 1987); *Grayson v. American Airlines, Inc.*, 803 F.2d 1097 (10th Cir. 1986). In considering a motion for summary judgment, the Court must view the evidence in the light most favorable to the party opposing the motion. *Lindley v. Amoco Production Co.*, 639 F.2d 671 (10th Cir. 1981). *See, also, Frito-Lay, Inc. v. Retail Clerks Union Local No. 7*, 629 F.2d 653 (10th Cir. 1980); *In re American Cable Publications, Inc.*, 62 B.R. 536 (D.Colo. 1986); *In re Mueller*, 34 B.R. 869 (Bankr.D.Colo. 1983).

B. *First Claim for Relief - 11 U.S.C § 547(b).*

A trustee
may avoid any transfer of an interest of the debtor in property–

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made–

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if–

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b).

The initial burden lies on the Trustee to establish the elements of Section 547(b) by a preponderance of the evidence. Once accomplished, the burden shifts to the Defendant to establish that one of the exceptions apply. *In re Financial Partners, Ltd.*, 116 B.R. 629, 634 (Bankr.N.D.Ill. 1989). 11 U.S.C. § 547(g). *See, generally, Union Bank v. Wolas*, __U.S.__, 112 S.Ct. 527, 529, 116 L.Ed.2d 514 (1991); *Vance v. Dugan*, 187 F.2d 605 (10th Cir. 1951).

As a preliminary matter, this Court is not persuaded by the Defendant's argument that, as a matter of public policy,

preference actions are not an available remedy when dealing with Ponzi schemes. *In re Independent Clearing House Co.*, 77 B.R. 843, 871 (D.Utah 1987) ("The equitable solution would be either to apply the [preference] statute to all transfers to investors in a Ponzi scheme--without regard to when the transfers were made--or to apply the statute to none of the transfers."). The *Independent Clearing House* court, although recognizing the potential inequities, found itself bound by the language of the statute.[5] This Court agrees. So too, this Court is not convinced that the equities all lie in the Defendant's favor, particularly in light of the fact that some of the Debtor's creditors are not "Private Investors."[6]

Moreover, under these circumstances, the argument for leaving the Defendant as he is found is clearly contrary to one of the Code's primary purposes, i.e., to treat all similar creditors equally.

The Direct Testimony of the Trustee, by Affidavit attached to her Brief, establishes that (1) property of Debtor was transferred, (2) the transfers were made within 90 days of the Petition, and (3) the transfers allowed the Defendant to receive more than he would have received under a Chapter 7 liquidation. Further, according to Direct Testimony of E. Jayne (McCarthy) MacPhee

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5. The Court concluded, "[y]et this court is no more free to rewrite the statute to bring the early [investors] into its net than it is to ignore the statute to treat later [investors] equally. Courts must apply the statute as written." *In re Independent Clearing House Co.*, 77 B.R. 843, 871 (D.Utah 1987).

6. Pre-petition trade debt totals approximately $20,000.00 and Chapter 11 administrative expenses for rent and wages exceed $50,000.00.

of Patten, McCarthy & Associates, by Affidavit attached to the Trustee's brief, Debtor was insolvent at the times that the various subject transfers were made.[7] The Defendant does not appear to contest these allegations. Also, the Defendant does not dispute the requisite elements of (1) his status as a creditor, and (2) payment made on account of an antecedent debt.

This particular case involves, predominantly, no issues of material fact in dispute. This Court, therefore, concludes that the Trustee has carried her burden of satisfying the five elements of Section 547(b) by essentially unrefuted factual recitals, and by a preponderance of the evidence.

Hence, the burden shifts to this Defendant to establish the applicability of an exception under Section 547(c) and/or factual disputes such that summary judgment cannot be awarded by virtue of subsection (c). *Financial Partners, supra* 116 B.R. at 634. *See, generally, In re Craddock,* 1992 WL 406394 (Bankr.D.Colo. 1992) ("Faced with a motion for summary judgment, supported by the claim with its evidentiary effect, the Debtor was obligated to come forward with evidence in the form of affidavits, stipulated facts, depositions or other discovery responses sufficient to either rebut the evidentiary effect of the proof of claim or to raise a dispute concerning a material fact. *Celotex Corp. v. Catrett,* [477 U.S. 317, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986)]; *Applied Genetics International, Inc. v. First Affiliated Securities, Inc.,* 912 F.2d 1238, 1241 (10th Cir. 1990).").

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7. Some courts have found that, "[b]y definition, an enterprise engaged in a Ponzi scheme is insolvent from day one." *Independent Clearing House, supra,* 77 B..R. at 871. As Debtor was an established business and continued to conduct legitimate business, at least to some degree, up until the date of the Petition, this Court cannot adopt such a blanket statement in the present case.

1. *First Claimed Preference Exception - 11 U.S C. § 547(c)(2).*

Defendant argues that the transactions fall within two exceptions to the preference statute. First, under the Bankruptcy Code, a trustee may not avoid an otherwise preferential transfer where the transfer was

> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
> (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2).

The Bankruptcy Code does not define "ordinary course of business" or "ordinary business terms" and the legislative history is sparse.[8] However, this Court construes that an underlying purpose of this exception is to leave undisturbed routine and normal financial transactions so as to protect customary business and credit relationships formed, or occasioned, as part of lawful commercial activity.

The term "ordinary," so pervasive in the statute, is the Court's benchmark for application of the exception.

> To satisfy the ordinary course of business exception, a creditor must show that the payments were made in the ordinary course of the creditor's business, made according to ordinary business terms, and made in the ordinary course of business.

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8. *See, In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 (6th Cir. 1989).

In re Meridith Millard Partners, 145 B.R. 682, 687 (D.Colo. 1992).

This exception to recovery of an otherwise preferential transfer should be narrowly construed. *See, In re Meridith Millard Partners*, 145 B.R. 682 (D.Colo. 1992); *J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 96 B.R. 474, 476 (D.N.J. 1988), *aff'd*, 891 F.2d 66 (3rd Cir. 1989). Moreover, in order to successfully advance the defense, all three elements under the statute must be satisfied by the Defendant. *Fidelity Savings and Investment Co. v. New Hope Baptist*, 880 F.2d 1172 (10th Cir. 1989).

While many courts have held that the ordinary course of business exception simply does not apply to transfers in furtherance of a Ponzi scheme,[9] this Court believes that such holdings may be simple over-generalizations designed to shortcut the process of applying the specific fact situations to

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9. *See, Henderson v. Buchanan*, 985 F.2d 1021 (9th Cir. 1993); *In re Bullion Reserve of North America*, 836 F.2d 1214 (9th Cir. 1988), *cert. denied, sub nom, Bozek v. Danning*, 486 U.S. 1056, 108 S.Ct. 2824, 100 L.Ed.2d 925 (1988); *Matter of Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.*, 819 F.2d 214 (9th Cir. 1987) (finding a Ponzi scheme is not a "business" thus not in "ordinary course of business"); *Wider v. Wootton*, 907 F.2d 570 (5th Cir. 1990); *In re Montgomery*, 123 B.R. 801 (Bankr.M.D.Tenn. 1991), *aff'd*, 136 B.R. 727 (M.D.Tenn. 1992), *aff'd*, 983 F.2d 1389 (6th Cir. 1993); *In re Baker & Getty Financial Services, Inc.*, 88 B.R. 792 (Bankr.N.D.Ohio 1988), *appeal decided by* 974 F.2d 712 (6th Cir. 1992); *In re Southern Indus. Banking Corp.*, 87 B.R. 524 (Bankr.E.D.Tenn. 1988).

the elements of the exception.[10] This is an appealing and convenient rule and may, indeed, prove to be good law, but this Court will briefly evaluate the exception in this case on its own merits.

Defendant may be able to demonstrate that the underlying debt and subject payments were made "in the ordinary course of business" between the Debtor and himself, particularly since the Trustee does not appear to dispute this point.[11] However, in order to successfully invoke the ordinary course of business exception under subsection (c)(2), the creditor here must deal with two elements of the subsection. The first element is in subsection (c)(2)(C) - payments - "made according to ordinary business terms."

Defendant alleges that the subject payments were "totally in conformity with...other entities engaged in the same type of fraudulent business." Defendant's Motion for Judgment with Accompanying Brief, at p.12. In short, Defendant argues, without substantiation, that the payments were "incurred in the ordinary course of this Debtor's **fraudulent business**." *Id.*

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10. *But see, Sender v. Walan,* Civil Action No. 92-F-924 (Chief Judge Finesilver of the District Court's jury instruction involving the exception read as follows:

> If you find that the debts owed by HIA, Inc. to AFW Hedged, Ltd. and Susan Walan were incurred because of HIA, Inc.'s fraud, you must find that AFW Hedged, Ltd. and Susan Walan have failed to prove the ordinary course of business defense.) (Emphasis added.)

11. As of yet, however, Defendant has presented no real evidence to establish this alleged course of dealing.

(emphasis added).[12] The Trustee counters that it is simply incredible to argue that such payments are within the ordinary course of business "**for a business machine sales and service company.**" Memorandum Brief in Opposition, at p.9 (emphasis added). While the Court believes the Trustee's argument is more sound and case law based, the Court concludes that both parties may well have missed the real question: Were these debts incurred and payments made according to common and ordinary business terms - period?

The Bankruptcy Code does not qualify this element, subsection (c)(2)(C), to make it necessarily subject to the particularities and peculiarities, or the specific practices, of one entity, a single category of commerce, or a specified area, but to "business," or to commerce, in general. *Accord, In re Schraiber*, 1992 WL 280801, at *17 (Bankr.N.D.Ill. 1992) (not reported in B.R.); *First Federal of Michigan v. Barrow*, 878 F.2d 912, 918 (6th Cir. 1989). Even if this Court were to find that the practices of one particular industry should be considered and controlling, then this Court would find that the practice of a business machine sales and service company would be the appropriate measure of business conduct, particularly in light of the Defendant's admitted intent to invest in such an endeavor.

In general terms, this Court finds that neither (1) a promissory note providing for grossly usurious interest rates,

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12. Defendant further argues that the Trustee has somehow admitted his status as falling within the ordinary course of business exception by way of an affidavit submitted in an unrelated case dealing with the existence and payment of ordinary trade debt is unpersuasive and borders on speciousness.

which is illegal under state law,[13] and to be paid by the issuance of a series of postdated checks, (2) coupled with payment in such a form, could possibly come under the penumbra of "ordinary business terms" with relation to either "business," or commerce. This finding applies equally well, perhaps more so, with regard to the operation of a business machine sales and service company, in particular. 11 U.S.C. § 547(c)(2).

Other judges in this District have made similar conclusions with respect to other Ponzi schemes. *See, Sender v. Greenlee,* Adversary Proceeding No. 91-1930-CEM (oral ruling rendered June 11,1992)[14] and *Sender v. Perczak,* Adversary Proceeding No. 91-1799-PAC (oral ruling rendered November 20, 1992).[15]

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13. The facts of this case allow an inference that Colorado law, civil and criminal, would impact the conduct and enforcement of these loan type transactions:

> Any person who knowingly charges, takes, or receives any money or other property as a loan finance charge where the charge exceeds an annual percentage rate of forty-five percent or the equivalent for a longer or shorter period commits the crime of criminal usury, which is a class 6 felony.

8B C.R.S. § 18-15-104(l) (1989).

See, C.R.S. § 5-12-103, wherein 45% rate of interest is fixed as a maximum permissible, enforceable rate of interest.

14. Chief Judge Matheson concluded, "[w]hen we have a company that is insolvent, not making money, reporting false profits and paying what it is falsely reporting, I hardly feel that that is an obligation or a payment made in the ordinary course of any reputable business. Certainly it's not one made according to ordinary business terms." Transcript, p. 16.

15. Judge Clark determined that it is not the ordinary course of business to misappropriate funds and return investments when the payor entity is insolvent.

A second important element in ascertaining whether this (c)(2) exception may be successfully invoked by the Defendant is whether the transfer was in payment of a "debt incurred by the debtor **in the ordinary course of business or financial affairs of ... the transferee** [Defendant]" ((c)(2)(A)), and made in the "**ordinary course of business ... of the transferee** [Defendant]" ((c)(2)(B)). What, after all, is the Defendant's ordinary course of business? Lending? Lending at usurious interest rates? Investing? Investing and taking back usurious promissory notes?

The Defendant here has not provided any evidence whatsoever, or advanced the argument, that **his ordinary business**, or financial affairs, involves lending at usurious and illegal interest rates, or otherwise taking promissory notes with usurious, illegal and unenforceable interest rates. If the Defendant was in that business, or was otherwise ordinarily engaging in a business arguably similar to "loansharking," then, perhaps, this exception to preferential recovery might, conceivably, be successfully advanced. The record now before the Court, and evidence proffered by the Defendant, provides no support for that position.

Accordingly, this Court finds that the requirements of the "ordinary course of business" exception contained in Section 547(c)(2) simply have not been satisfied in the present situation. Therefore, the ordinary course of business exception has not been properly invoked by this Defendant and it does not serve to protect the payments at issue from recovery by the Trustee.

2. *Second Claimed Preference Exception - 11 U.S.C. § 547(c)(4).*

Defendant next argues that the transactions fall within the "new value" or partial "subsequent value" exception expressed at Section 547(c)(4). A trustee may not avoid an otherwise preferential transfer where the transfer was

> to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor--
>
> (A) not secured by an otherwise unavoidable security interest; and
>
> (B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

11 U.S.C. § 547(c)(4).

"New value" for purposes of Section 547 is

> money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.

11 U.S.C. § 547(a)(2).

Defendant argues that he gave "new value," or made subsequent advances by check to the Debtor which effectively "cured" a portion of the preferential transfers.[16] The Trustee argues,

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16. The Trustee's Exhibit V establishes the following sequence of events:

DATE	INVESTOR DEPOSITS TO DEBTOR	DEBTOR'S PAYMENTS TO INVESTOR
7/30/90		$10,000.00
8/3/90		$750.00
8/28/90		$10,000.00
9/5/90		$750.00
9/7/90	$50,000.00	
9/10/90	$25,000.00	
9/10/90	$25,000.00	
9/21/90		$4,000.00
9/24/90		$4,000.00
9/26/90		$10,000.00
10/1/90		4,000.00
TOTAL:	$100,000.00	$43,500.00

however, that the "new value" must constitute a material benefit to the estate and that monies used merely to perpetuate a Ponzi scheme do not meet the requirements of the exception.[17] *See, Independent Clearing House, supra* 77 B.R. at 859. This Court reads neither Section 547(c)(4) nor Section 547(a)(2) to necessarily require a material benefit to the estate. It appears that "new value," in the form of money, was indeed subsequently advanced by Defendant to the Debtor. *Accord, Jobin v. Brown,* Adversary No. 91-1607-RJB (Memorandum Opinion and Order on Summary Judgment dated October 26, 1992, at p.4).

A question arises however: In order for the "new value" exception to be viable and serve as a bar to Trustee's preference avoidance and recovery, must the "new value" remain unpaid, in whole or in part, as of the debtor's bankruptcy filing? *See, In re White River Corp.,* 50 B.R. 403, 409-410 (Bankr.D.Colo. 1985), *rev'd on other grounds,* 799 F.2d 631 (10th Cir. 1986). Subsequent to *White River,* this Circuit has provided little guidance in this area. *See, In re Electronic Metal Products, Inc.,* 916 F.2d 1502 (10th Cir.), *reh'g denied,* December 21, 1990 ("net result rule" rejected).

The "overwhelming majority" of courts have previously held that the "new value" must remain unpaid in order for Section 547(c)(4) to apply. *In re American Int'l Airways, Inc.,* 56 B.R. 551, 554 (Bankr.E.D.Pa. 1986) (cases cited). More recently, however, the "trend ... is in the opposite direction: holding that new value need not remain unpaid based upon exhaustive analysis of the underpinnings of the legislative and statutory framework." *In re Ladera Heights Community Hospital Inc.,* 152 B.R. 964 (Bankr.C.D.Cal. 1993). The court in *Ladera Heights* observed, in a lengthy and well-reasoned opinion, that:

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17. No allegations have been made concerning the existence of an otherwise unavoidable security interest granted to the creditor pursuant to Section 547(c)(4)(A).

> [T]he plain language of Section 547(c)(4) contains no requirement that new value must remain unpaid. [Citation omitted.] The legislative history... is equally devoid of language imposing such a requirement. Most telling, however, is the fact that Congress deleted the restrictive language of the former Section 60(c) which limited the new value exception to 'the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy.'

Id., at 968 (emphasis added).

The view of the law adopted by the *Ladera Heights* court appears to "comport[ ] not only with the language of the statute and congressional intent, but also serve[ ] the legislative goal of encouraging creditors to maintain business relationships with financially troubled enterprises by recognizing the commercial realities of these transactions." *Id.*, at 969. (One might argue that this Court should not be concerned with encouraging third-parties to continue paying money into, and thereby perpetuating a Ponzi scheme. Such a distinction based upon a particular factual situation is neither supported by the Bankruptcy Code nor apparent in expressed legislative intent.[18] This Court finds, moreover, that such an interpretation does not do violence to the ultimate holding of *White River* or similar (though scarce) cases in this District.

This Court concludes that application of Section 547(c)(4) to the present case is appropriate, in part, and protects the first four payments at issue, or $21,500.00, but not the final four

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18. Such an argument leads to the proverbial "slippery slope." Without expressed and explicit legislative intent to refrain from applying this, or any other Code provision, to debtors in particular "businesses," the subjective moral interpretations of the various Courts would prevail and lead to dramatic uncertainty across the country.

payments totalling $22,000.00, from recovery by the Trustee as preferential transfers.[19]

C. *Second Claim for Relief - 11 U.S.C. § 548(a)(l).*

A trustee may avoid a transfer of property or any obligation incurred by a debtor that was made or incurred

> within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> > (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted.

11 U.S.C. § 548(a)(1).

The affidavits submitted in support of the Trustee's Motion for Summary Judgment set forth uncontroverted evidence that transfers of Debtor's property occurred and that the transfers occurred within one year of the bankruptcy filing. The only issue which remains is the Debtor's intent. The Trustee must prove actual fraudulent intent. A court may, and in many cases must, rely on circumstantial evidence in making a finding of actual intent. *Fish v. East,* 114 F.2d 177 (10th Cir. 1940); *In re Faires,* 123 B.R. 397 (Bankr.D.Colo. 1991); *In re Booth,* 70 B.R. 391 (Bankr.D.Colo. 1987). *See,* C.R.S. §§ 38-8-105 and 38-1-117.

> Fraudulent intent may be established, and usually must be, by circumstantial evidence or by inferences drawn from a course of conduct. Subsequent conduct, itself, is often probative of a debtor's intent on a prior occasion. *In re Farmers Cooperative Ass'n of Talmage, KS v. Strunk,* 671 F.2d 391(10th Cir. 1982).

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19. This conclusion does not necessarily mean that $21,500.00 is absolutely protected from recovery by the Trustee. See, continued discussion, infra.

In re Greenwalt, 63 B.R. 555, 559 (Bankr.D.Colo. 1986).

When faced with a similar Ponzi scheme, one court found as follows:

> One can infer an intent to defraud future [Ponzi participants] from the mere fact that a debtor was running a Ponzi scheme. Indeed, no other reasonable inference is possible. A Ponzi scheme cannot work forever. The investor pool is a limited resource and will eventually run dry. The perpetrator must know that the scheme will eventually collapse as a result of the inability to attract new investors. The perpetrator nevertheless makes payments to present investors, which, by definition, are meant to attract new investors. He must know all along, from the very nature of his activities, that investors at the end of the line will lose their money. Knowledge as to a substantial certainty constitutes intent in the eyes of the law...and a debtor's knowledge that future investors will not be paid is sufficient to establish his actual intent to defraud them. [Citation omitted.]
>
> Although the question of the debtor's intent would ordinarily present a factual question, we conclude that, from the undisputed evidence in the record, only one inference is possible–namely, that the debtors had the intent to hinder, delay or defraud creditors. The trustee's undisputed evidence is that the debtors were engaged in a Ponzi scheme and therefore must have known that the [participants] at the end of the line would lose their money. That is the only evidence there is.
>
> *Independent Clearing House, supra* 77 B.R. at 860.

This Court believes that the reasoning and conclusion of the District Court sitting *en banc* in *Independent Clearing House*, is sound and legally correct. This Court can and does make similar inferences from the essentially unrebutted evidence produced, regarding the intent of the Debtor, and in so doing, determines that judgment should be entered in the Trustee's favor on Count Two (Section 548(a)(1)) as a matter of law.

D. *Third Claim for Relief - 11 U.S.C. § 548(a)(2).*

Similarly, a trustee may avoid a transfer of property or any obligation incurred by a debtor that was made or incurred

> within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> * * *
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a)(2).

For purposes of Section 548,

> 'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor.

11 U.S.C. § 548(d)(2)(A).

The affidavits submitted in support of the Trustee's Motion for Summary Judgment set forth uncontroverted evidence that transfers of Debtor's property occurred, that the transfers occurred within one year of the bankruptcy filing, and that each of (not just one of) the elements in Section 548(a)(2)(B) are present. Defendant contests only the sole remaining element, the issue of "reasonably equivalent value." 11 U.S.C. § 548(a)(2)(A).

Defendant argues that the payments he received reduced his restitution claim[20] against the Debtor and that the reduction of the restitution claim provided "reasonably equivalent value." The Trustee concedes that, in some instances, reduction of a restitution claim may provide "value."[21] The Trustee argues that a factual question exists on this issue however because

> [i]f investments were made with culpable knowledge, all subsequent payments made to such investors within one year . . . would be avoidable . . . regardless of the amount invested, because the debtors would not have exchanged a reasonably equivalent value for the payments.
>
> *In re United Energy Corp.*, 944 F.2d 589, 596 n. 7 (9th Cir. 1991) (citing *Independent Clearing House, supra* 77 B.R. at 857-858.)

The Trustee maintains that payment of usurious interest "coupled with the use of post-dated checks, the circumstances under which investors were enlisted in the scheme, and the caliber of those involved in peddling the 'investments,' served to put [Defendant] and others on notice of the fraudulence [sic] involved in the transactions." Memorandum Brief in Opposition, p. 38-39. Such "knowledge, actual or constructive, measured by an objective standard, negates the claim that 'reasonably equivalent value' was given. Significant genuine issues of material fact concerning what [Defendant] knew or

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20. *See, In re United Energy Corp.*, 944 F.2d 589, 596 (9th Cir. 1991) (defrauded investors "clearly had claims for rescission and restitution [against the debtor] which arose when they bought the [investment], regardless of whether there existed a contractual right to the return of principal").

21. The Trustee appears to have subsequently backed away from this concession. Trustee's Supplemental Response to Defendant's Motion for Summary Judgment, at p. 1.

should have known, given the circumstances, remain at issue." *Id.*, at 39.

This Court finds that, while it appears to be generally uncontroverted that "value" in the form of a reduction in Defendant's restitution claim has been given, an issue of material fact remains as to the Defendant's state of mind which goes directly to the "reasonably equivalent" element so as to preclude entry of summary judgment on the Third Claim for Relief.[22] *See, generally, In re PERMA Pacific Properties*, 983 F.2d 964, 968 (10th Cir. 1992) ("Although the intent or state of mind of the parties is not materially dispositive of whether or not a transfer is a preference,... we can see no impediment to allowing the bankruptcy court to look at the nature of the transaction and the relationship among the parties.").

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22. Defendant also argues that the exception established by Section 548(c) (taking for value and in good faith) applies here. The unsubstantiated statements made by Defendant that he

> did not know [Debtor] was a Ponzi scheme either before or during the duration of his investment, and that he was unaware that [Debtor] was insolvent when he received interest payments [and] ... that he was an unwitting investor who, like hundreds of others, was defrauded by [Debtor] causing him to lose substantial funds [and] ... that Defendant ... was, at all times, acting in good faith

are insufficient by themselves to carry Defendant's burden as to this defense, particularly in light of the Trustee's arguments to the contrary. Defendant's Motion for Summary Judgment with Accompanying Brief, at p.7. Further, the question of "good faith" almost by necessity demands a factual inquiry by the Court, therefore, summary judgment is inappropriate.

E. *Fourth Claim for Relief - 11 U.S.C. § 549.*

With regard to the final $4,000.00 payment made[23] to Defendant on October 1, 1990, the day that the Voluntary Petition was filed, the Trustee argues alternatively (1) that the payment occurred pre-petition and should be treated just like the other seven pre-petition payments, or (2) that the payment occurred post-petition and was not authorized either by the Bankruptcy Code or by Court order. 11 U.S.C. § 549(a).[24]

As the Voluntary Petition does not indicate the time on October 1, 1990 that it was filed, this Court is unable to determine with any degree of certainty which came first, the "chicken" (petition) or the "egg" (payment on the check). Fortunately, in light of the instant determination, it makes no difference in the ultimate result. If payment occurred pre-petition, it would be treated like the other payments that clearly occurred pre-petition. If payment occurred post-petition, it was

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23. In actuality, the check was tendered sometime prior to October 1, 1990. The check was paid or honored by the Bank on October 1, 1990. *See, Barnhill v. Johnson*, __U.S.__, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992).

24. Defendant contends that the payment was "certainly within the ordinary course of this Debtor's business" and, thus, authorized by Section 363(c)(1) without Court approval. Defendant's Motion for Summary Judgment with Accompanying Brief, p. 14. 11 U.S.C. § 549(a)(2)(B). As this Court has previously determined, one is hard-pressed to establish that continuance of a Ponzi scheme pre-petition is "in the ordinary course of business." This Court finds that the conclusory statement cited above utterly fails to establish that the provisions of the Bankruptcy Code would embrace the ability of a debtor to continue a Ponzi scheme post-petition without Court approval or supervision.

unauthorized. Summary judgment should enter in favor of the Trustee on Count Four as well.

F. *Fifth Claim for Relief - 11 U.S.C. §§ 542 and 550.*

The final claim is for recovery and turnover of amounts determined to be avoidable under prior claims for relief. This claim is not explicitly a subject of the pending cross-motions for summary judgment.

III. CONCLUSION.

For the reasons cited herein, it is

ORDERED that Defendant's Motion for Summary Judgment filed December 4, 1992 is DENIED, IN PERTINENT PART, as to:

1. Application of Section 547 to "Ponzi Schemes" (First Claim);

2. Defending the Trustee's preference claims pursuant to the "ordinary course of business" exception (Section 547(c)(2)) (First Claim).

3. Defending the Trustee's fraudulent transfer claim pursuant to Section 548(a)(1) and (a)(2); the latter involving questions of fact to be determined at trial (Second and Third Claims).

IT IS FURTHER ORDERED that the Defendant's Motion for Summary Judgment filed December 4, 1992 is GRANTED, IN PERTINENT PART, as to:

1. Application and use of the "new value" exception to Trustee's preference claims pursuant to Section 547(c)(4) (First Claim).

IT IS FURTHER ORDERED that Trustee's Cross-Motion for [Partial] Summary Judgment filed February 8, 1993 is GRANTED, IN PERTINENT PART, as to:

1. The application of 11 U.S.C. § 547 to Ponzi schemes in general (First Claim).

2. Satisfaction of the elements of 11 U.S.C. § 547(b)(1)-(5) establishing the event of preferential transfers to this Defendant (First Claim).

3. Failure of Defendant to establish the elements of his "ordinary course of business" defense (Section 547(c)(2)) (First Claim).

4. Satisfaction of the elements of transfers made to hinder, delay, or defraud creditors, pursuant to Section 548(a)(l) (Second Claim).

5. Relief under the recovery of post-petition alternative claims for relief pursuant to Section 549 (Fourth Claim).

IT IS FURTHER ORDERED that Trustee's Cross-Motion for [Partial] Summary Judgment filed February 8, 1993 is DENIED, IN PERTINENT PART, as to:

1. Failure of Defendant to establish the elements of the 11 U.S.C. § 547(c)(4) "new value" defense (First Claim).

2. Trustee's claims for a transfer without reasonably equivalent value pursuant to Section 548(a)(2) (Third Claim).

Dated: May 26, 1993

BY THE COURT
Sidney B. Brooks,
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO

In re:	)	
	)	
M & L BUSINESS MACHINE COMPANY, INC.,	)	Bankruptcy Case No 90-15491-CEM
Debtor.	)	
	)	
CHRISTINE J. JOBIN, Trustee of the Estate of M & L Business Machine Co., Inc.,	)	
Plaintiff,	)	
	)	
v.	)	
	)	Adversary
PERRY S. MCKAY,	)	Proceeding No.
Defendant.	)	92-2199-SBB

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER

THIS MATTER comes before the Court upon the trial of the issues not decided in the Motion and Cross-Motion for Summary Judgment, decided by a Memorandum Opinion and Order originally entered: May 5, 1993. *In re M&L Business Machine Co., Inc.*, __B.R.__, 1993 WL 180899 (Bankr.D.Colo. May 26, 1993). More specifically, the issues before the Court at trial and treated in this opinion are (1) the Trustee's avoidance claim on a "transfer for less than reasonably equivalent value," under 11 U.S.C. § 548(a)(2), and (2) the Defendant's "good faith" affirmative defense asserted under 11 U.S.C. § 548(c) to the Trustee's claims asserted under Sections 548(a)(1) and

(a)(2). The Court, having reviewed the file, conducted a trial, and reviewed the evidence before it, enters the following findings of fact, conclusions of law, and order.

I. *FINDINGS OF FACT*

An extensive overview of the facts related to M&L Business Machine Company, Inc. ("M&L" or "Debtor" and its operation of a Ponzi, or pyramid, scheme, and the ensuing bankruptcy and appointment of Christine J. Jobin ("Jobin" or "Trustee") as Chapter 7 Trustee herein is contained in this Court's May 5, 1993 Memorandum Opinion and Order. *In re M&L Business Machine Co, Inc.*, ___ B.R. ___, 1993 WL 180899 (Bankr.D.Colo. May 26, 1993). Those findings of fact are adopted herein.

1. The Defendant, Perry S. McKay ("McKay" or "Defendant") was an investor in, or lender to, M&L commencing June 1990.[1] He invested a total of $207,500.00 between the period of June 19, 1990 and September 10, 1990, and received distributions totalling $43,500.00 from M&L. All such distributions were made within the 90 days prior to the filing of the petition.

2. McKay was given two unsecured promissory notes (Trustee's Exhibit T) in exchange for some of his transfers to M&L. The returns on his first two investments were 10% per month or 120% per year. His last two investments were paying 9% per week or an annualized return of 468%. (Trustee's Exhibit R.) At the time of each of his four investments, McKay

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1. Typically, "investments" were "loans," as well. Advances by the "investors" were repaid pursuant to post-dated checks written by the Debtor, payable to the "investor," or "lender."

was given a post-dated check which he could negotiate as the date which appeared on the check arrived.

3. McKay is not uneducated or inexperienced in the area of finance. He has had three years of college at Northwestern University in Chicago, Illinois; he studied business administration and took some classes in bookkeeping. He is familiar with the difference between audited and unaudited financial statements and has prepared and/or reviewed financial statements in conjunction with his businesses and/or farm operations.

4. At one time McKay owned his own construction business in California and operated it profitably as a sole proprietorship in the late 1970's before voluntarily closing it down in the early 1980's when he sensed a downturn in the real estate market. He readily admitted that the real estate market in 1990, when he received distributions from M&L, was not paying nearly the rate of returns offered by M&L although he did indicate he had been able to turn one piece of residential property for a significant profit years earlier.

5. As a co-trustee for a family trust holding assets with a collective value in excess of $3,000,000.00, McKay currently operates a commercial and industrial real estate business which either owns, operates or develops parcels of real estate. He operates an industrial park in Golden, Colorado and developed a 35,000 square foot Federal Express terminal in Englewood.

6. As a co-trustee, he is familiar with a number of different financing arrangements having employed same in the acquisition of the real estate parcels mentioned hereinabove on behalf of the trust. These arrangements include the $3,475,000.00 purchase of the industrial park where the trust

assumed a $1,800,000.00 debt payable at an annualized rate of 9.5%. The balance of the funds came from the trust. On behalf of the trust, McKay uses the cash flow from the park to service the approximate $12,000.00 per month debt service requirements on the assumed debt.

7. The Federal Express project was purchased for a $1,400,000.00 assumption with $350,000.00 cash down. The rate of interest on the assumed debt was 9.5% per annum.

8. Also, he personally owns a farm or ranch operation which is customarily financed in the fall of each year with a line of credit payable at the annualized rate of 11%. He testified he never paid rates higher than 12%, and that he understood a line of credit as an arrangement by which cash is made available immediately to the borrower.

9. In addition to being a co-trustee on a family trust with assets in excess of $3,000,000.00, McKay served as a trustee for Boulder College in the late 1980's through February 1990.

10. Although the family trust primarily has interests in real estate, his personal portfolio in 1990 (when he began investing in M&L) included a variety of stocks and bonds, which he traded through several brokers, mutual funds, raw land and promissory notes other than those given by M&L. McKay subscribed to at least three investment publications and had funds in numerous accounts including a Prudential Bache Command Account from which he transferred funds for his investment in M&L.

11. At the time he was investing in M&L, McKay held two other promissory notes payable to him. One was secured and in the face amount of $192,000.00 paying interest at the rate of 9% per annum; the other had been executed by a friend in

the amount of $37,500.00, and was unsecured and payable at the rate of 11% per annum. Payments on these notes were regular in nature and no checks had been returned for insufficient funds during 1990.

12. In addition to his apartment in Boulder, McKay owns a residence in Ft. Lauderdale, Florida, on which he has an outstanding mortgage of approximately $44,000.00. The applicable interest rate on this obligation in 1990 was 10% per annum.

13. McKay was first introduced to the M&L operations by Dr. Alec Tsoucatos, an economics professor, former President of Boulder College, and long-time acquaintance who had apparently been involved with M&L for some time. McKay testified that he learned shortly after his first investment that Tsoucatos had received a commission for bringing him to M&L. Nevertheless, he continued to invest and did not question anyone about the apparent "brokerage" arrangement. The testimony is clear that Tsoucatos was not a financial broker by profession and that McKay was familiar with the use of, and, indeed, had frequently used, registered brokers in certain of his other investments.

14. After being told about M&L by Tsoucatos, McKay visited the corporate offices of M&L in Westminster and spoke with Daniel Hatch and Dale Krug, representatives of M&L. He based his investment, in part, on the fact that the offices seemed well-appointed and that the employees seemed busy and articulate. He was in the office for approximately 45 minutes to one hour. He stated that he did not find it strange that a business conducting national, perhaps international, sales in the alleged amount of $57,000,000.00 per year had only 10-12 employees on the premises at the time of his visit. He

thought others might be in the other offices located in cities indicated on the letterhead or on other floors of the same building. No evidence was presented that he attempted to contact or verify the existence of these other offices or asked about the whereabouts of other employees.

15. McKay inquired as to how M&L could pay the enormous "investment" returns that it did. He was told that the investors' cash payments to M&L allowed it to obtain the equipment at much better prices than could be had otherwise. He was told that this effectively allowed M&L to "leverage" the deals on which it was working and undercut the competition. McKay was not told who the "competition" was. Although he was told the funds for each "program" were solicited with particular upcoming contracts in mind, he was not told nor did he inquire into which contracts his funds were being used. All he was told was that M&L anticipated supplying a large volume of equipment to an unspecified school board in Sacramento, California. Although he was told that M&L had contracts with certain "Fortune 500" companies, including AVIS car rental, American Airlines, and American Express, he was also told that confidentiality required that the specific contracts and names of others with whom M&L had contracted remain undisclosed. McKay neither undertook to verify any contracts nor asked to see even redacted versions of a sample contract.

16. McKay testified he was told that the use of private lenders allowed M&L to act more quickly on contracts without the "constraints" and "red tape" imposed by conventional lenders. Nevertheless, he was told that the private lenders comprised only a small portion of the overall financing of M&L. He did not ask the identity of the more conventional

lenders, neither did he undertake to contact them. In this regard it is also important to note he did not ask about limits to existing lines of credit with the conventional lenders or inquire as to the debt to any of these lenders.

17. McKay never asked how many other "private lenders" or "investors" were involved, who they were, or references regarding same.

18. McKay never attempted to contact the manufacturers from whom the equipment was to be purchased.

19. McKay testified that when reviewing the limited M&L financial information supplied, he was not very concerned with the liabilities of the company, but concerned himself with only the projections for sales and sales history. He justified this by saying that he came from a marketing background and he was thus oriented.

20. He testified that he only looked at financial statements for 1988 and 1989, the first quarter statement for 1990, and the sales projections for 1990. Although he did review the "Audited Report" for 1988 marked as Trustee's Exhibit D, he never contacted the auditors nor did he attempt in any way to verify the information contained therein. The documents which he has offered as exhibits show the extent of his documentary inquiry and include a one page "Fact Sheet" which provides very little fact about the company and a one page "History and Ownership" statement with one line at the bottom of the page which states "Projected sales for 1990 are estimated at 100 million." Curiously, although McKay maintains projected sales was the item of real importance to him, this is the only reference in the documents which he has offered to the Court which even reference projected sales and it provides no basis to support the projection.

21. McKay also reviewed biographical sketches on Robert Joseph and Daniel Hatch (Defendant's Exhibits 15 and 16) which show Joseph with technical education and background and Hatch with a psychology and computer science degree. Neither sketch shows either officer of the company with any education or training in finance except for Joseph's reference to "business administration" at Denver Community College.

22. The only other documents submitted by McKay in support of his claim that he conducted some reasonable inquiry into M&L before investing were four pages for the "1989 3rd and 4th Quarter Participation Programs." Two of the four pages are cover pages and the other two are duplicates of each other and contain no information about the company of any value. McKay testified, however, that he thought the documents were complete.

23. McKay testified that he did not ask for or review any M&L prospectus although he had, on other occasions, asked for prospectuses with respect to other mutual fund investments which paid considerably lower rates of return.

24. In large part, McKay testified that a main feature of his "due diligence" inquiry with respect to M&L was the recommendation of his friend. He never requested any corporate report such as a Dunn & Bradstreet on M&L. Moreover, while McKay did mention the M&L investment to his personal accountant, he did not seek his accountant's advice before proceeding.

25. McKay testified that the type of investment opportunity offered by M&L would not be appropriate for his family trust although he did discuss the M&L investment with the co-trustee.

26. McKay admitted that if he, as a trustee, could obtain funds for 10% annually, it made little sense to pay many times that rate as M&L had done, and was doing in this, McKay's, transaction.

27. Significantly, the first check McKay tried to negotiate from M&L was returned for insufficient funds. (Trustee's Exhibit U.) McKay testified that he presented the check in person at the Bank of Boulder where he was initially told the check would be immediately credited to his account. A few days later, he received notice that the check had been returned. He testified that he was concerned and that he went to the bank and spoke with Mr. Ratteree, a bank officer, about the matter. McKay testified that originally he thought it was either a banking error or "growing pains" of M&L, a company that was skyrocketing financially and that Mr. Ratteree indicated that the bank was "working on the problem" and that he would be meeting with Robert Joseph later that night to discuss the problem. Not satisfied with this explanation, McKay called Daniel Hatch and left a message. Joseph returned the call a few days later and told McKay the problem had been corrected. The bank ran the check back through and it cleared.

28. McKay testified that sometime during the summer of 1990, Tsoucatos told him to hold his checks for a period of five days after the date indicated on each check before trying to negotiate them. McKay testified that Tsoucatos told him that this had happened before but that if he waited five days on each check, it could be cashed. McKay complied with the request and waited five days before presenting each check. No other checks bounced.

29. McKay testified that he first learned of the filing of the Voluntary Petition on the day it was filed, October 1, 1990,

when he was called aside in a restaurant by Tsoucatos. With respect to a review of the bankruptcy pleadings or file, McKay testified that he did not review the file but that his counsel may have.

30. McKay first learned that fraud was involved when he read a *Denver Post* article explaining the finding of the boxes of bogus inventory. He did not dispute that this article came out in February 1990. On March 19, 1990 he filed a proof of claim in the amount of $212,250.00 in the M&L proceeding. (Trustee's Exhibit T.) This amount was exactly what was left owing on the post-dated checks he was holding, and his proof of claim for the full amount was submitted even after he had knowledge of the fraud.

31. Ken Wester, a rebuttal witness examined by the Trustee, testified that during 1988 or 1989 he had learned of M&L through David Parrish. Parrish and his wife had frequented Wester's jewelry store in Westminster. Wester testified that Parrish twice solicited Wester and his wife to invest in M&L. The first time Wester was asked to invest $25,000.00 and was promised 30% per month interest. Wester declined this solicitation. The second time Wester was solicited he was promised 20% per month. When Wester asked why the interest rate was not 30%, Parrish told him that the interest rate was determined by how much cash M&L needed at any particular time. Again, Wester declined the solicitation because he believed the interest rates promised could not be real and that something had to be wrong. Wester also testified that he is a gemologist by occupation and that he completed only two years of college in Worcester, Massachusetts, where he took some general business courses.

II. *CONCLUSIONS OF LAW*

Many of the threshold legal issues in this case were decided in this Court's May 5, 1993 Order on Motions for Summary Judgment. *M&L Business Machine Co., Inc., supra.* Two remaining issues are treated here. First, did the Debtor receive less than "reasonably equivalent value" for the Debtor's payments to McKay, which payments the Trustee seeks to avoid pursuant to Section 548(a)(2)[2] and, second, did the Defendant act in "good faith," as that term is used in 11 U.S.C.

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2. Section 548 (a)(2) states as follows:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548 (a)(2).

This Court earlier granted summary judgment to the Trustee against this Defendant on Trustee's fraudulent transfer claim under Section 548 (a)(1).

§ 548(c), so as to bar the Trustee's recovery on her "fraudulent" transfer claims.[3]

The Defendant maintains, in his defense against the Trustee's claims, essentially, that (1) the Debtor received "reasonably equivalent value" for the payments the Debtor made to McKay, which payments the Trustee seeks to recover, and (2) that he acted in good faith in his transactions with M&L and, particularly, in receiving payments or the allegedly "fraudulent" transfers, from M&L. The Court agrees with the Defendant McKay that the Debtor did, indeed, receive reasonably equivalent value in exchange for the payments, but the Court disagrees that Defendant acted in good faith. The Court concludes that, under the circumstances and evidence produced in this particular case, the Defendant-investor, or lender, McKay, did not act in good faith; he did not take the transfers in good faith.

1. *Trustee's "Fraudulent Transfer Claim" - 11 U.S.C. 548(a)(2).*

Under 11 U.S.C. § 548(a)(2), a trustee may avoid any transfer of an interest of the debtor in property that was made on or within one year before the date of filing the petition, if the debtor received "less than a reasonably equivalent value in exchange for such transfer," and the debtor was insolvent or

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3. Section 548 (c) states as follows:

(c) Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c).

was made insolvent by the transaction.[4] The Court concludes that in the instant case, Debtor received "reasonably equivalent value" in exchange for the subject transfers.

"Value" is defined under § 548(d)(2)(A) as "property, or satisfaction or securing of a present or antecedent debt of the debtor...." Although the term "antecedent debt" is not defined in the Code, the term "debt" means "liability on a claim." 11 U.S.C. § 101(12). In turn, "claim" is broadly defined to mean either a right to payment, whether or not such right is reduced to judgment, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, unsecured, or a right to an equitable remedy for breach of performance. 11 U.S.C. § 101(5).

In *In re United Energy Corp.*, 944 F.2d 589 (9th Cir. 1991), the trustee sought to avoid alleged fraudulent transfers to investors in a Ponzi scheme. In *United Energy Corp.*, the Ninth Circuit noted that the defrauded investors "clearly had claims for rescission and restitution [against the debtor] which arose when they bought the [investment], regardless of whether there existed a contractual right to the return of principal." *Id.*, at 596, *citing, In re Independent Clearing House Co.*, 77 B.R. 843 (D.Utah 1987).

Continuing, the court concluded that, therefore, the defrauded investors held claims against the debtor and that those claims fit within the broad definition of "debt." As investors were repaid money from the Ponzi scheme, their rights to restitution from the debtor were proportionately reduced. *United Energy Corp., supra.* Similarly, in *Independent*

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4. The issue of insolvency has been conceded by Defendant in this proceeding and was not an issue for trial.

Clearing House Co., supra, also involving a Ponzi scheme, the District Court stated:

> Thus, to the extent the debtors' payments to a defendant [investor] merely repaid his principal undertaking, the payment satisfied an antecedent 'debt' of the debtors, and the debtors received 'value' in exchange for the transfers. Moreover, to the extent a transfer merely repaid a defendant's [investor's] undertaking, the debtor received not only a 'reasonably equivalent value' but the exact same value - dollar for dollar. We therefore hold that such transfers are not avoidable under section 548(a)(2).
>
> *Independent Clearing House Co., supra* at 857.

This Court has previously concluded that "it appears to be generally uncontroverted that 'value' in the form of a reduction in Defendant's restitution claim has been given." *M&L Business Machine Co., Inc., supra.* The Court agrees with *Independent Clearing House Co.* that because the investor's restitution claim is decreased dollar for dollar with each transfer that is received from a Ponzi scheme, not only has "value" been given in exchange for the transfer, but "reasonably equivalent value" has been given.

Here, it is not disputed that Defendant invested the total sum of $207,500.00 into M&L and was only able to cash checks totalling $43,500.00. That is Defendant lost, on an out-of-pocket basis, the sum of $164,000.00 and still has a restitution right to same. As such, the Court concludes that the Debtor received "reasonably equivalent value," i.e., a reduced claim by McKay for restitution or rescission.

The Court rejects Trustee's argument that by filing a proof of claim in March of 1991 for $212,250.00 (Plaintiff's Exhibit "T"), Defendant has somehow waived his right to claim that value was given. The issue is not what Defendant stated M&L

owed him (which statement was made over two years ago), but rather, as a legal matter, whether Defendant had a right to restitution the instant he made his investments. The Court concludes that the Defendant did have a right to restitution as soon as he made his investments in M&L. *United Energy Co., supra.* Moreover, at trial, Defendant's counsel stated the proof of claim would be amended to reflect a claim of $164,000.[5] It is also perhaps noteworthy that the Trustee has not, apparently, filed any objection to the proof of claim.

2. *Defendant's "Good Faith" Defense § 548(c)*

This Court concludes that, in accord with Section 548(c), an objective test is appropriate and legally correct to measure the "good faith" conduct of a transferee in a fraudulent recovery effort by the Trustee pursuant to Section 548(a). The Court further concludes that this specific transferee, McKay, under these particular circumstances, did not act in good faith. The Section 548(c) "good faith" defense is not a bar to the Trustee's avoidance and recovery in the instant action.

The Defendant argues that a "subjective test" is appropriate, and required by case law, in measuring "good faith"; the Trustee argues for use of an objective test.

In *In re Agricultural Research and Technology Group, Inc.*, 916 F.2d 528 (9th Cir. 1990), a case involving a similar Ponzi

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5. Taking judicial notice of the file, the Court notes that an amended proof of claim was filed by this Defendant in the amount of $164,000.00. Amendments to proofs of claim should be freely permitted, and this Court will, for purposes at least of this adversary, allow the amended proof of claim to be filed. *See, In re Unioil, Inc.*, 962 F.2d 988 (10th Cir. 1992). *See, generally, In re Padget*, 119 B.R. 793 (Bankr.D.Colo. 1990).

scheme, the court evaluated "good faith" in a similar situation. The court noted that:

> Even if the transferee gave reasonably equivalent value in exchange for the transfer avoided on either of the alternate theories, the transferee may not recover such value if the exchange was not in good faith because good faith is 'indispensable' for the transferee who would recover any value given pursuant to 11 U.S.C. § 548(c)....
>
> *Id.*, at 535.

The court analyzed the reasoning and case law relative to findings of "good faith" in "fraudulent transfer" avoidance and recovery actions. The court, first, recognized that the burden of proof as to a "good faith" transfer, under Section 548(c), lies with the transferee, here the Defendant McKay. *In re Candor Diamond Corp.*, 76 B.R. 342, 351 (Bankr.S.D.N.Y. 1987); *In re Health Gourmet, Inc.*, 29 B.R. 673, 677 (Bankr.D.Mass. 1983). The court then distinguished the cases using, or purporting to use, a subjective test, and ruled that:

> These pronouncements indicate that courts look to what the transferee objectively 'knew or should have known' in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint. Therefore, appellants' reference to the subjective assertions of good faith in the Grant affidavit are of no moment.
>
> *Agricultural Research and Technology Group Inc., supra* at 535-536.

See, Shauer v. Alterton, 151 U.S. 607, 621, 14 S.Ct. 442, 446, 33 L.Ed. 286 (1894). *See also, Harrell v. Beall*, 84 U.S. (17 Wall.) 590, 21 L.Ed. 692 (1873).

In *Agricultural Research and Technology Group*, the court found that returns promised had no apparent realistic

connection with the marketability, or the market value, of the product that was the subject of the Ponzi scheme. *Id.* at 532. In analyzing the "good faith" element the court, citing earlier cases, concluded that:

> [K]nowledge or actual notice of circumstances sufficient to put [the transferee], as a prudent man, upon inquiry as to [the intent to defraud creditors]...should be deemed to have notice ...as would invalidate [the transfer].
>
> *Id.*, at 535.

The case law cited therein indicates that courts would look to what the transferee objectively "knew or should have known" in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint. This analysis applies to the defense under Section 548(c). At least one other case has indicated that the issue turns on what diligent inquiry would have discovered with respect to the fraudulent purpose. *See, In re Polar Chips Int'l, Inc.*, 18 B.R. 480 (Bankr.S.D.Fla. 1982).

This Court believes the reasoning and conclusion of the District Court in *Agricultural Research and Technology Group* is sound and legally correct. This Court adopts the "objective standard" and rejects the "subjective standard" advanced by the Defendant.

Defendant McKay cites two paramount and central reasons for maintaining that his investments in, or loans to M&L, as well as receiving payments, or transfers, from M&L were undertaken in "good faith." First, he claims he reasonably relied on the recommendation of M&L by his friend Alec Tsoucatos, who was, ostensibly, experienced in business, financially astute, and claimed to have had a successful prior investment record with M&L. Second, he argues that he reasonably relied on the clever and obviously persuasive,

explanation of the M&L representatives, Daniel Hatch and Dale Krug, as to how M&L could afford to pay interest rates, or returns on investment, greatly in excess of, indeed 10 to 40 times, market rates.

The Court concludes that these two reasons cited by McKay, standing alone or even coupled with the other features of M&L's sales scheme, in the context of the circumstances at the time of McKay's investments, are simply insufficient to demonstrate his objective good faith.[6] McKay has not carried his burden.

First, a recommendation from a commission-earning friend is, at a minimum, a red flag; it is a dubious pillar on which to risk large investments. The Court also notes that, perhaps significantly, there was no corroborating or supporting evidence on this point supplied by the Defendant.[7]

Second, the elaborate and convoluted explanation by Daniel Hatch and Dale Krug as to how M&L could pay rates of return 10 to 40 times market rates was simply not credible; it was not plausible, at least under the scrutiny of a reasonable and prudent investor. McKay is an educated, experienced, savvy investor. He knew and understood business practices,

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6. At the risk of sounding trite or supercilious, the Court recalls the old saw that "if it sounds too good to be true, it probably is!" The rates of return offered to and relied on by McKay were roughly 10 to 40 times what was available to McKay (and everyone else) in the marketplace. That is too good to be true...on virtually any standard.

7. Tsoucatos was not called to testify. No supporting evidence of any sort was submitted to demonstrate the accuracy, reliability, veracity, or bona fides of Tsoucatos vis-a-vis M&L, or his successes in business, finance, or otherwise.

principles, operations, and concepts.[8] He knew and understood the ins and outs of rather complicated business "deals" and complex commercial transactions.

These two findings, coupled with the cumulative impact of the following features of this case, persuade the Court to conclude the Defendant did not, based on objective standards, act in good faith: (a) McKay's business knowledge, and the variety, extent and sophistication of his own business experiences, (b) the range of, and disparity between, the prevailing market rates of return and M&L's promised rate of return, (c) McKay's recognition of the unusual and high risk nature of the investment... too unusual and risky for his trust, (d) M&L's routine use of postdated checks in loan/investment transactions, (e) McKay's rather cursory inquiry and lack of care and due diligence in investigating an investment situation which, on its face, appeared extraordinary and phenomenal, and (f) M&L's initial "bounced" investment repayment check to McKay.

This conclusion as to McKay's lack of good faith, as that term is used in Section 548 (c), is one based on the facts of this case. This Court contemplates, indeed expects, that among the estimated 1,600 investors of M&L there are those who, indeed, acted in "good faith." Each of those cases must be decided on its own merit. Each case and each investor's situation must be examined and evaluated on its own facts, and they would include, presumably, facts and features similar to those identified in this case.

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8. He readily understood, for example, concepts like "market rates of interest" and the use and availability of "lines of credit" for business operations.

This conclusion regarding objective "bad faith" (more accurately lack of good faith) should not be construed as a determination by the Court of malicious intent, malevolence, or nefarious scheming by McKay - or of a lack of his credibility. The Court does not find he was malicious, malevolent, nefarious or not credible. He simply did not invest in M&L and receive payments from M&L in a good faith manner as measured by an objective - not subjective - standard.

For the reasons recited herein, the Court finds (1) for the Defendant and against the Trustee on her "fraudulent transfer" claim pursuant to Section 548(a)(2), and (2) in favor of the Trustee and against the Defendant on his "good faith" affirmative defense pursuant to Section 548(c).

IT IS THEREFORE ORDERED that judgment shall, in accordance with this Opinion and this Court's May 26, 1993 Memorandum Opinion and Order, enter in favor of the Trustee and against the Defendant as follows:[9]

1. In favor of the Trustee, Christine J. Jobin, and against the Defendant, Perry S McKay, for payments made by Debtor to the Defendant pursuant to 11 U.S.C. § 547 (and § 549) in the amount of $22,000.00, plus interest;

2. In favor of the Trustee, Christine J. Jobin, and against the Defendant, Perry S. McKay, for payments made by Debtor to the Defendant pursuant to 11 U. S. C. § 548 (a)(1) in the amount of $43,500.00, plus interest; and

3. In favor of the Defendant, Perry S. McKay, on the Plaintiff's claim pursuant to 11 U.S.C. § 548(a)(2).

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9. Implicit are Trustee's claims pursuant to 11 U.S.C. §§ 542 and 550 as well. Judgment amounts awarded are not cumulative.

Dated this 10th day of June 1993.

BY THE COURT:
Sidney B. Brooks,
United States Bankruptcy Judge

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Civil Action No. 93-K-1321

In re M & L BUSINESS MACHINE COMPANY, INC.,

Debtor.

CHRISTINE J. JOBIN, Trustee of the Estate of M & L Business Machine Co., Inc.,

Plaintiff/Appellee/Cross-Appellant,

v.

PERRY S. McKAY,

Defendant/Appellant/Cross-Appellee.

MEMORANDUM DECISION ON APPEAL

KANE, Senior District Judge

In this bankruptcy appeal and cross-appeal, Perry S. McKay and Christine J. Jobin, trustee of the bankruptcy estate of M & L Business Machine Co., Inc. ("trustee"), contest the bankruptcy court's May 26, 1993 order on summary judgment, 155 B.R. 531, and its June 10, 1993 findings of fact and conclusions of law following trial on the trustee's preference and fraudulent conveyance action against McKay. In his appeal, McKay argues that the bankruptcy court erred: (1) by applying an objective standard in determining whether McKay received certain

transfers in "good faith" under 11 U.S.C. § 548(c) and in concluding that McKay lacked "good faith" under that section, (2) by finding that preference actions under 11 U.S.C. § 547 are available to a trustee in a Ponzi scheme, (3) in precluding McKay from using the 11 U.S.C. § 547(c)(2) "ordinary course of business defense" to the trustee's preference claims, and (4) in failing to decide whether the trustee's claims were barred as compulsory counterclaims which should have been asserted in *Amazing Enterprises v. Jobin (In re M & L Business Machine Co.)*, 136 B.R. 271 (Bankr.D.Colo. 1992). In her cross-appeal, the trustee argues that the bankruptcy court erred in finding that McKay was entitled to assert a restitution claim, the reduction of which constituted "reasonably equivalent value" under 11 U.S.C. § 548(a)(2)(A). I affirm.

I. *Facts*

M & L Business Machines Company, Inc. ("M & L") had operated as a computer sales leasing firm since its inception in the 1970's. On October 1, 1990, it filed for Chapter 7 bankruptcy protection. Soon thereafter, it converted the case into a Chapter 11 reorganization. On December 18, 1990, Jobin was appointed Chapter 11 trustee. In February 1991, she discovered that much of M & L's boxed inventory contained bricks and dirt and suspected that M & L's principals had used the corporation as a front for a Ponzi and/or check kiting scheme. When the scheme collapsed, approximately $83,000,000 in post-dated, unpaid checks remained in the hands of various private investors, even though over $74,000,000 flowed through M & L's bank accounts from January through December, 1990.

On September 26, 1991, the trustee converted the case into Chapter 7 liquidation and has since commenced over 400 adversary proceedings to avoid transfers and recover property

of the estate. The trustee filed the instant proceeding against McKay on September 30, 1992, seeking to recover $43,500 paid to McKay within ninety days of the filing of the petition under 11 U.S.C. §§ 547, 548 and 549. The facts are essentially undisputed. I adopt the findings of fact contained in the bankruptcy court's ruling on summary judgment and after trial. (*See* R.Doc. 45 at 2-4; R.Doc. 47 at 1-9.) I will review only those facts relevant to my analysis.

Between June 19, 1990 and September 10, 1990, McKay invested a total of $207,500 in M & L and received distributions totalling $43,500. At the time of each of his four investments, he was given postdated checks which he could negotiate as the date which appeared on the check arrived. He made his initial investment of $100,000 on June 19, 1990. This was to be a two year investment generating $10,000, or ten percent per month, or an annualized return rate of 120%. He received an unsecured promissory note in exchange for this investment. He cashed three interest checks, each in the amount of $10,000, before the filing of the bankruptcy petition. McKay's second investment was for $7,500 on June 26, 1990, apparently also a two-year investment generating ten percent per month. McKay received and cashed two interest checks for this investment, each in the amount of $750. He also received an unsecured promissory note in exchange for this investment. His third investment was for $50,000 on September 7, 1990. This investment was to mature on October 5, 1990 and to pay $4000, or nine percent per week. Two interest checks cleared the bank before the bankruptcy filing. McKay's final investment was for an additional $50,000, paid in two checks of $25,000 each, on September 10, 1990. It was again structured to yield nine percent per week, although only one check in the amount of $4,000 was cashed before the filing.

The parties dispute whether McKay should have known that he was investing in a Ponzi scheme. McKay was not inexperienced in financial matters. He had three years of college at Northwestern University in Chicago, Illinois; he studied business administration and took some classes in bookkeeping. He at one time profitably operated his own construction business in California before voluntarily closing it. As a co-trustee for a family trust holding assets with a collective value in excess of $3,000,000, McKay currently operates a commercial and industrial real estate business and is familiar with a number of different financing arrangements. He personally owns a ranch operation which is customarily financed with a line of credit payable at an annualized rate of eleven percent.

When he began investing in M & L in 1990, McKay's personal portfolio included a variety of stocks and bonds, which he traded through several brokers, mutual funds, raw land and promissory notes other than those given him by M & L. McKay owns an apartment in Boulder and a residence in Ft. Lauderdale, Florida with an outstanding mortgage of approximately $44,000 on which the applicable rate of interest was ten percent per annum in 1991.

McKay learnt of M & L through Dr. Alec Tsoucatos, an economics professor, the former president of Boulder College and a long-time acquaintance, who had apparently been involved with M & L for some time. McKay testified that the main feature of his "due diligence" inquiry with respect to M & L was the recommendation of Tsoucatos. He visited the offices of M & L on one occasion and spoke with M & L representatives. In response to his inquiry, he was told that M & L could pay the high returns that it did because the investors'

cash payments allowed it to obtain computer equipment at better prices than could be had otherwise so that it could undercut its competitors. He examined limited financial information regarding M & L.

The first check that McKay tried to negotiate, dated July 19, 1990, was returned by the Bank of Boulder for "uncollected funds," although the bank had initially told him that his account would be credited immediately with the funds. He spoke with a bank officer about the matter and was told that the officer would be meeting with Robert Joseph, M & L's president, that night to discuss the problem. McKay nevertheless called M & L and, in response to his message, received a return call from Joseph who informed him that the problem had been corrected. The bank itself then redeposited the check which cleared. During the summer of 1990, Tsoucatos told McKay to wait five days on each check before presenting them for payment. McKay complied and no other checks bounced.

McKay testified that he first learned of the filing of the voluntary petition on the day it was filed, October 1, 1990, when Tsoucatos called him aside in a restaurant and first learned that fraud was involved from an article in the Denver Post in February 1990. On March 19, 1990, he filed a proof of claim in the amount of $212,250 in the M & L proceeding, which was that amount owing on the post-dated checks in his possession.

II. *Standard of Appellate Review*

In reviewing a bankruptcy court decision, I must accept the court's findings of fact, whether based on oral or documentary evidence, unless they are clearly erroneous. Bankr.R. 8013; *Branding Iron Motel, Inc. v. Sandlian Equity, Inc. (In re Branding*

Iron Motel, Inc.), 798 F.2d 396, 399-400 (10th Cir. 1986). I must also give due regard to the bankruptcy court's opportunity to judge the credibility of the witnesses. *Id.* Conclusions of law are reviewed *de novo*. *Id.*

III. *Merits*

A. *Standard for "good faith" under 11 U.S.C. § 548(c)*

Section 548 of the Bankruptcy Code permits a trustee to avoid certain fraudulent transfers of the debtor. Here, the trustee sought to avoid the $43,500 McKay received from M & L in the year preceding bankruptcy under § 548(a)(1) and § 548(a)(2) of the Code. While unsuccessful on the § 548(a)(2) claim, she prevailed on her § 548(a)(1) claim. McKay now argues on appeal that he is nevertheless entitled to avoid liability on the § 548(a)(l) claim under § 548(c) of the Code, because he received the transfers in good faith. The parties dispute whether the standard for determining good faith is an objective or subjective one. This is an issue which I must review *de novo*.

Section 548(c) of the Bankruptcy Code provides:

> Except to the extent that a transfer or obligation voidable under the section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c). In its decision following trial, the bankruptcy court undertook a review of case law addressing the applicable test to measure the "good faith" requirement on

the part of a transferee attempting to raise a defense under § 548(c) where a trustee seeks to avoid a fraudulent transfer under § 548(a).[1] McKay argued that a subjective test was appropriate, while the trustee argued that an objective test applies. The bankruptcy court concluded that an objective test is applicable, relying principally on *Hayes v. Palm Seedling Partners-A (In re Agricultural Research & Technology Group, Inc.)*, 916 F.2d 528, 535-36 (9th Cir. 1990). In that decision, the Ninth Circuit concluded that "courts look to what the transferee objectively 'knew or should have known' in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint. . . . At least one court has held that if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." *Id.*, (referring to *Sanitary Ice Vending Co. v. Harris (In re Polar Chips Int'l Inc.)*, 18 B.R. 480 (Bankr.S.D.Fla. 1982)).

McKay submits that several cases support a subjective test of "good faith" under § 548(c). None of theses cases, however,

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1. The bankruptcy court had earlier granted summary judgment to the trustee against McKay on the trustee's fraudulent transfer claim under 11 U.S.C. § 548(a)(l) which states:

> (a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted....

expressly addresses the issue in terms of subjective or objective tests. Rather, the cases he cites emphasize the requirement that a court should determine whether a transferee acted in "good faith" on the facts of each case. McKay's reliance on *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 861-62 (D.Utah 1987), is misplaced. There, the court acknowledged that, "[c]ertainly, if a defendant knew that the debtor was running a Ponzi scheme when he advanced money to the debtor or knew of the debtor's insolvency at the time of the alleged fraudulent transfer, that knowledge might indicate a lack of good faith." *Id.* However, the court further acknowledged that "'the presence of any circumstance placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith unless investigation actually disclosed no reason to suspect financial embarrassment.'" *Id.* at 862 (citing 4 *Collier on Bankruptcy* ¶ 548.07[2] at 548-68 (L. King. 15th ed. 1987). The decision does not favor either a subjective or objective test but merely states that whether a transferee acts in good faith is an issue of fact on which the bankruptcy court should take evidence. *Id.* Under this view, an inquiry into the facts of any particular case will be relevant to a determination of a transferee's "good faith", irrespective of the test chosen.

Similarly, *Practical Investment Corp. v. Rellen (In re Practical Investment Corp.)*, 95 B.R. 935 (Bankr.E.D.Va. 1989), does not address the "good faith" issue in terms of a subjective versus objective test. Rather, the court laid emphasis on the facts of each particular case in making such determination. *Id.* at 942-944.

In *Gilmer v. Woodson*, the Fourth Circuit determined that the rationale of the referee's conclusion of a lack of good faith was

"not entirely clear" but seemed to have been that the transferee "had been a close personal friend and the regular legal counsel for the [debtors] for several years" and thus "should have known that [they] were insolvent at the time the deed of trust was given." 332 F.2d 541, 546-47 (4th Cir.), *cert. denied*, 379 U.S. 834, 85 S.Ct. 67, 13 L.Ed.2d 42 (1964). The court held that "good faith" is not lacking unless the transferee "knowingly participated in the debtor-transferor's purpose to defeat other creditors." *Id.* While *Gilmer* apparently supports a subjective test, the basis for the court's reversal was the absence of proper subjective or objective findings of the referee to warrant his conclusion.

Although I can find no direct Tenth Circuit authority on the test for "good faith" under § 548(c), several bankruptcy court cases within the circuit expressly apply the objective standard enunciated in *In re Agricultural Research*, 916 F.2d at 535-36. *See e.g., Jobin v. Lalan (In re M & L Business Machine Co.)*, 160 B.R. 851, 858 (Bankr.D.Colo. 1993) ("This Court adopts the standard of 'objective' good faith rather than 'subjective' good faith."); *Jobin v. Waukau (In re M & L Business Machine Co.)*, Adversary Proceeding No. 92-2683 RJB, slip op. at 2 (Bankr.D.Colo. September 1, 1993) and *Jobin v. McFadden (In re M & L Business Machine Co.)*, Adversary Proceeding No. 92-2785 RJB, slip op. at 2, 1993 WL 625593 (Bankr.D.Colo. July 2, 1993).[2]

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2. McKay suggests that I should look to Colorado state law for guidance in this regard. I have reviewed the analogous Colorado fraudulent conveyance law and cannot agree that it conclusively supports a subjective, rather than objective standard. Besides, state law is irrelevant. Federal law applies.

I find that the weight of authority supports the bankruptcy court's view that the "good faith" requirement under § 548(c) is to be determined by an objective, rather than subjective, test.

B. *Conclusion that McKay Lacked Good Faith*

McKay next argues that the bankruptcy court's finding that he lacked good faith was clearly erroneous. McKay bears the burden of proof in establishing that he received the transfers in good faith. *In re Agric. Research & Technology Group*, 916 F.2d at 535. The bankruptcy court reviewed in detail the relevant evidence, and, applying an objective test of good faith, concluded that McKay had not discharged his burden. In summary the court found that a recommendation from a commission earning friend (Tsoucatos) is at minimum a red flag and a dubious pillar on which to risk large investments and, that the explanation of the principals of M & L as to how M & L could pay rates of return ten to forty times market rates, was not plausible. These two findings coupled with the following factors led the court to its conclusion: the level of McKay's business knowledge and experience, the disparity between the prevailing market rates of return and M & L's promised rate of return, McKay's recognition of the unusual and high risk nature of the investment . . .too unusual and risky for his family trust, M & L's routine use of postdated checks in loan/investment transactions, McKay's rather cursory inquiry and lack of care and due diligence in investigating an investment situation which, on its face, appeared phenomenal, and M & L's initial "bounced" investment repayment check to McKay. (*See* R.Doc. 47 at 17-18.) Giving due regard to the bankruptcy court's opportunity to judge the credibility of the witnesses (*In re Branding Iron Motel, Inc.*, 798 F.2d at 399), I find

that it's conclusion was not clearly erroneous and, accordingly, I affirm.

C. *Applicability of Preference Claims to a Ponzi Scheme*

McKay challenges the bankruptcy court's finding in its summary judgment ruling that § 547 preference claims are available to a trustee in a Ponzi scheme. On an appeal from an order granting summary judgment, I must apply the same standards as the court below, reviewing its conclusions de novo. *Applied Genetics Int'l, Inc. v. First Affiliated Sec., Inc.*, 912 F.2d 1238, 1241 (10th Cir. 1990).

McKay argues that, as a matter of public policy, all transfers in a Ponzi scheme are preferential since, from its inception, such scheme is insolvent. He cites *In re Independent Clearing House Co.*, 77 B.R. 843, 871 (D.Utah 1987) in support of this contention. While the *Independent Clearing House* court recognized the potential inequities, it found itself bound to "apply the statute as written." *Id.* McKay also relies on *American Continental Corp. v. All Preference Defendants (In re American Continental Corp.)*, in which the court found that "the equities of this case require that the Preference Litigation not go forward." 142 B.R. 894, 900 (D.Ariz. 1992). The court noted that the debtor's bonds were sold through branches of Lincoln Savings, which had "had the outward appearance of a legitimate operation and in certain respects, it may have been." *Id.* The court was convinced, in the circumstances of that case, that all the equities lay in favor of the bond holders and that they should all share equally in the available assets. *Id.*

In the present circumstances, even if I am not bound by the language of the statute, the equities are not clearly in favor of all private investors in the Ponzi scheme. First, not all of M&L's

creditors are private investors.[3] Second, the circumstances of each private investment differ and have to be examined individually to determine where the equities lie. I therefore apply the statute as written and confirm the bankruptcy court's finding that § 547 preference claims are available to the trustee in this case.

D. *Ordinary Course of Business Exception*

McKay further challenges the bankruptcy court's summary judgment ruling that the "ordinary course of business or financial affairs" exception contained in the Bankruptcy Code 11 U.S.C. § 547(c)(2) did not apply to the facts of this case. As noted above, while I will not set aside the bankruptcy court's factual findings unless they are "clearly erroneous," I must review its conclusions of law de novo. A § 547(c)(2) determination is, however, a "peculiarly factual one" and therefore due deference is given to the decision of the bankruptcy court. *In re J. P. Fyfe, Inc. of Florida v. Bradco & Supply Corp.*, 96 B.R. 474, 476 (D.N.J. 1988).

Under the Bankruptcy Code, a trustee may not avoid an otherwise preferential transfer, to the extent that the transfer was

> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
> (C) made according to ordinary business terms.

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3. M&L's trade debt on the date of the petition in this matter totalled approximately $20,000 and its Chapter 11 administrative expenses for rent and wages will exceed $50,000. (Appellee's Appeal Br. at 31.)

11 U.S.C. § 547(c)(2). To except a transfer under the ordinary course of business exception, a creditor must prove all three of the stated elements. *Fidelity Savings & Inv. Co. v. New Hope Baptist*, 880 F.2d 1172, 1177 (10th Cir. 1989). Moreover, the exception should be narrowly construed. *In re J.P. Fyfe, Inc. of Florida*, 96 B.R. at 476.

Several courts have held that, as a matter of law, the ordinary course of business defense is not applicable to payments received from one engaged in a Ponzi scheme, regardless of the good faith or knowledge of the transferee. *See, e.g., Henderson v. Buchanan*, 985 F.2d 1021, 1025 (9th Cir. 1993); *Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214, 1219 (9th Cir. 1988), *cert. denied*, 486 U.S. 1056, 108 S.Ct. 2824, 100 L.Ed.2d 925 (1988); *Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)*, 819 F.2d 214, 216-17 (9th Cir. 1987); *In re Taubman*, 160 B.R. 964, 991 (Bankr.S.D.Ohio 1993). These courts have adopted the following rationale:

> While "ordinary course of business" is not expressly defined in the Bankruptcy Code, it appears that the purpose of 547(c)(2) was to protect from preference ordinary trade credit transactions that are kept current, including payment of monthly utility bills. S.Rep. No. 95-989, 95th Cong., 2d Sess. 88 (1978), 1978 U.S.Code Cong. & Admin.News, p.5874.

In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc., 819 F.2d at 216-17. "Reading the ordinary course of business exception in the light of the purpose behind Section 547(c)(2), it is clear that Congress did not intend to protect one group of investors in a 'Ponzi' scheme over the rest." *Id.* at 217. "The exception applies to payments by a real business, not to payments by a fake business set up to defraud people." *Duvoisin v. Evans (In re*

Southern Indus. Banking Corp.), 159 B.R. 224, 227 (Bankr.E.D.Tenn. 1988).

The bankruptcy court acknowledged this line of authority but, rather than simply reject the ordinary course of business exception as inapplicable to a Ponzi scheme, it examined the facts and concluded that McKay had failed to satisfy all three requisite elements of § 547(c)(2). This is the very approach adopted by the court in *In re Independent Clearing House Co.*, one of the principal cases on which McKay relies, when it held that "[a] transfer does not fall outside the scope of section 547(c)(2) simply because it was made in furtherance of a Ponzi scheme." 77 B.R. at 875. In *In re Independent Clearing House*, the district court remanded the case, holding that the defendants would still have the burden of showing that the transfers in question met all requirements of § 547(c)(2). *Id.*

In the present case, the bankruptcy court found that McKay had failed to satisfy § 547(c)(2)(C) in that he did not show that the transfers were "made according to ordinary business terms." The court noted that the Bankruptcy Code does not qualify this element but found that, even if the practices of a particular industry are controlling, in this case, the appropriate measure of business conduct would be the practice of a business machine sales and service company. The court went on to find that, neither the promissory notes providing for usurious interest rates, nor payment by issuance of a series of post-dated checks, indicated that the transfers were "made according to the ordinary business terms" of a business machine sales and service company.

McKay argues that the bankruptcy court erred in looking to the standard practice of a business machine sales and service company since, by admission of all, including the trustee, M&L

was a Ponzi scheme. McKay cites *In re Independent Clearing House Co.*, in support of his rather astonishing contention that the "ordinariness" of the transactions in the Ponzi scheme were to be determined by comparing them with other similar fraudulent businesses. *Id.* at 874-75. However, in that very case, the court noted:

> By section 547(c) Congress meant to "leave undisturbed normal financial relations [of the debtor], because [they do] not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." H.R.Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), reprinted in 1978 U.S.Code Cong. & Admin.News 5963, 6329.

Id. at 874. Even applying a Ponzi scheme standard, the focus of the inquiry "must be directed to an analysis of the business practices which were unique to the particular parties under consideration and not to the practices which generally prevailed in the industry of the parties." *Waldschmidt v. Ranier (In re Fulghum Const. Corp.)*, 872 F.2d 739, 743 (6th Cir. 1989). Section 547(c)(2) was intended to "'protect recurring, customary credit transactions which are incurred and paid in the ordinary course of business of the Debtor and the transferee.'" *Id.* (citing *Energy Co-op., Inc. v. SOCAP Int'l, Ltd. (In re Energy Co-op., Inc.)*, 832 F.2d 997, 1004 (7th Cir. 1987)). Here, all the transfers which McKay received from M&L were within the ninety-day period before the date of the filing of the petition and may be construed as "unusual action" during M&L's "slide into bankruptcy." Therefore, no past terms of business exist between M&L and McKay from which to determine if the transfers under consideration were made "in the ordinary course of business" or according to "ordinary business terms." *Id.; see also Marathon Oil Co. v. Flatau (In re Craig Oil Co.)*, 785 F.2d 1563, 1566-67 (11th Cir. 1986).

For these reasons, I find no error in the bankruptcy court's ultimate conclusion that the transfers to McKay were out of the ordinary course of business and not according to ordinary business terms.

E. *Compulsory Counterclaims*

McKay argues that the trustee's claims were compulsory counterclaims which should have been asserted in the prior case of *Amazing Enterprises v. Jobin (In re M&L Business Machine Co.)*, 136 B.R. 271 (Bankr.D.Colo. 1992). The trustee maintains that McKay abandoned this argument in his closing argument before the bankruptcy court. McKay asserts that he requested the bankruptcy court to rule on this issue and sought leave to file a supplemental brief before the court issued its ruling. He states that leave was denied and the bankruptcy court did not rule on the issue.[4]

In *Amazing Enterprises*, McKay, as a co-plaintiff with at least forty other investors, brought an action against the trustee for a declaration that their state court claims against non-debtor third parties were not assets of the estate and that the trustee had no standing to assert such claims on the investors' behalf.

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4. The court is prejudiced by the fact that, although McKay designated as part of the record the transcript of closing argument conducted on May 10, 1993, the record did not include such transcript. McKay later informed the clerk of the bankruptcy court that he did not wish to have this portion of the transcript (closing argument) transcribed. "It is the appellant's duty to make certain that the record on appeal is sufficient to enable this Court to make a meaningful review of any matter urged as ground for reversal." *United States v. Quarry*, 614 F.2d 245, 246 (10th Cir. 1980). However. even if McKay's argument regarding the compulsory counterclaim was not abandoned, I find it is without merit.

The trustee brought a counterclaim asserting issues of standing to assert other claims. The bankruptcy court entered judgment in favor of the investors. On appeal, I confirmed that the trustee lacked standing to pursue the claims of McKay and other investors against the principals of M&L. *See* 160 B.R. 850, 851 (D.Colo. 1993).

The Bankruptcy Rules provide that Fed. R.Civ.P. 13, relating to compulsory counterclaims, applies in adversary proceedings. Bankr.R. 7013. Rule 13 provides, in pertinent part:

> A pleading shall state as a counterclaim any claim which at the time of serving the pleading the pleader has against any opposing party, if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim and does not require for its adjudication the presence of third parties of whom the court cannot acquire jurisdiction.

Fed.R.Civ.P. 13(a).

McKay cites *Pullman Construction Industries, Inc. v. United States of America & Illinois Department of Revenue (In re Pullman Construction Industries, Inc.)*, 142 B.R. 280, 283-86 (Bankr.N.D.Ill. 1992), where the court held that a § 547(b) preference action was a compulsory counterclaim. In *In re Pullman*, the court addressed the issue of whether a debtor's preference action to recover tax payments was a compulsory counterclaim to the government's claim to recover unpaid taxes. Relying on *Burlington Northern Railroad Company v. Strong*, 907 F.2d 707, 710-11 (7th Cir. 1990), the court applied the "logical relationship" test and found that the debtor's claim arose out of the same transaction or occurrence and therefore was a compulsory counterclaim. *In re Pullman*, 142 B.R. at 283. The court in *Burlington* however, noted that "there is no formalistic

test to determine whether suits are logically related. A court should consider the totality of the claims, including the nature of the claims, the legal basis for recovery, the law involved, and the respective factual backgrounds." 907 F.2d at 711-12 (footnote omitted).

Amazing Enterprises was a declaratory judgment action which focussed on the narrow issue of the trustee's standing to pursue the claims of several investors against the principals of M&L. The instant suit, however, contains a wide range of allegations dealing with the specific transactions between McKay and the M&L corporation and goes far beyond the discrete issue that the court in *Amazing Enterprises* was asked to decide. *See Republic Health Corp. v. Lifemark Hosp. of Florida*, 755 F.2d 1453, 1455 (11th Cir. 1985). Taking into account the differing nature of the respective claims and law involved in the declaratory judgment action as opposed to the subject action, I find that the trustee's claims were not compulsory counterclaims in *Amazing Enterprises*.

F. *Reasonably Equivalent Value under 11 U.S.C. § 548(a)(2)*

In her cross-appeal, the trustee challenges the bankruptcy court's finding upon trial that McKay gave M&L "reasonably equivalent value" within the meaning of 11 U.S.C. § 548(a)(2). This section states in pertinent part as follows:

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of filing of the petition, if the debtor voluntarily or involuntarily—
>
> ...
>
> (2)(A) received less than a reasonably equivalent value in exchange for such transfer or obligation.

11 U.S.C. § 548(a)(2)(A).

"Value" is defined under § 548(d)(2)(A) as "property, or satisfaction or securing of a present or antecedent debt of the debtor." Although the term "antecedent debt" is not defined, the Bankruptcy Code defines "debt" as "liability on a claim." *Id.* § 101(12). "Claim" is defined as either a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured, or a right to an equitable remedy for breach of performance. *Id.* § 101(5).

To support its conclusion that McKay gave reasonably equivalent value, the bankruptcy court relied on two cases: *In re Independent Clearing House*, 77 B.R. at 857 and *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 596, n. 7 (9th Cir. 1991). In *In re Independent Clearing House Co.*, which also involved a Ponzi scheme, the court reasoned that

> to the extent the debtors' payments to a defendant [investor] merely repaid his principal undertaking, the payments satisfied the antecedent "debt" of the debtors, and the debtors received "value" in exchange for the transfers. Moreover, to the extent a transfer merely repaid a defendant's undertaking, the debtor received not only a "reasonably equivalent value" but the exact same value–dollar for dollar. We therefore hold that such transfers are not avoidable under section 548(a)(2).

77 B.R. at 857.

In this case, the bankruptcy court noted that, since it was undisputed that McKay invested the total sum of $207,500 in M&L and was only able to cash checks totalling $43,500, McKay effectively lost $164,000 for which he has a right to restitution. As such, M&L had received "reasonably equivalent

value" in the form of a reduction in McKay's restitution claim. The trustee could not, therefore, avoid any transfer to McKay under 11 U.S.C. § 548(a)(2) on the grounds that M&L had received "less than a reasonably equivalent value in exchange for such transfer" because of M&L's right to reduce the amount of McKay's restitution claim.

In *In re United Energy Corp.*, the Ninth Circuit held that defrauded investors in a Ponzi scheme "clearly had claims for rescission and restitution [against the debtor] which arose when they bought the [investment], regardless of whether there existed a contractual right to the return of principal." 944 F.2d 589, 596 (9th Cir. 1991). Accordingly, the Ninth Circuit concluded that the defrauded investors held claims against the debtor, which claims fell within the broad definition of "debt". Further, that as investors were repaid money from the Ponzi scheme, their rights to restitution from the debtor were proportionately reduced. *Id.* at 595.

The trustee submits that the bankruptcy court overlooked the following reasoning in *In re United Energy Corp.*:

> In recognizing these claims for rescission and restitution, we assume that the investors had no knowledge of the fraud the debtors were perpetrating. If investments were made with culpable knowledge, all subsequent payments made to such investors within one year of the debtors' bankruptcy would be avoidable under section 548(a)(2), regardless of the amount invested, because the debtors would not have exchanged a reasonably equivalent value for the payments. *Cf. In re Independent Clearing House Co.*, 77 B.R. at 857-58.

944 F.2d at 596, n. 7. The trustee argues, on appeal, that, because the bankruptcy court found that McKay did not act in good faith under § 548(c), he cannot succeed in his restitution claim

and therefore cannot defeat the trustee's claim under § 548(a)(2). I disagree.

As urged by the trustee, the bankruptcy court found that the test to be applied in determining whether McKay received the transfers from M&L "in good faith" for the purposes of § 548(c) is an objective one. The bankruptcy court further found that McKay did not receive the transfers in objective good faith. Notably, however, the bankruptcy court expressly stated:

> This conclusion regarding objective "bad faith" (more accurately lack of good faith) should not be construed as a determination by the Court of malicious intent, malevolence, or nefarious scheming by McKay–or of a lack of his credibility. The court does not find he was malicious, malevolent, nefarious or not credible. He simply did not invest in M&L and receive payments from M&L in a good faith manner as measured by an objective–not subjective–standard.

(R.Doc. 47 at 18.)

The court in *In re United Energy Corp.* made the assumption that "the investors had no knowledge of the fraud that the debtors were perpetrating" when it recognized the investors claims for rescission. 944 F.2d at 596, n. 7. Here, the bankruptcy court distinguished between an objective good faith test under § 548(c) and a subjective test for the purposes of determining McKay's claim for rescission and "reasonably equivalent" value under § 548(a)(2)(A).[5] The bankruptcy court made no finding

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5. After the hearing of oral argument in this case, the trustee and McKay each filed a copy of Judge Clark's Order on Motions and Cross-Motions for Summary Judgment in *Jobin v. Cervenka (In re M&L Business Machine Co.)*, Adversary Proceeding No.92-2192 PAC. slip op., 1994 WL 131097 (Bankr.D.Colo. February 4, 1994). In that ruling. Judge Clark did not distinguish between an objective good faith test

that McKay had knowledge of the fraud, only, that he did not invest in M&L or receive payments from M&L in a good faith manner, applying an objective standard. I must accept this finding of fact by the bankruptcy court since it is not clearly erroneous. Bankr.R. 8013.

The trustee further argues that, by filing a proof of claim in March 1991 for $212,250 (the amount owing on post-dated checks in his possession), after he had obtained knowledge of the fraud in February 1990, McKay somehow waived his right to restitution and, therefore, to claim that value was given.[6] I

(fn. 5 cont'd)
under § 548(c) and a subjective test under § 548(a)(2)(A). Without requiring an evidentiary hearing on the issue of Cervenca's good faith, the bankruptcy court concluded:

> In the instant case, the payment of usurious interest coupled with the use of post-dated checks, the circumstances under which investors were enlisted in the scheme, and the caliber of those involved in peddling the investments, put Mr. Cervenka, a Doctor of Chiropractic, on notice of the fraud. That knowledge, actual or constructive is sufficient when measured by an objective standard to negate the claim that reasonably equivalent value was given in good faith.

Id. at 6-7 (footnote omitted).

I disagree with the *Cervenka* court's approach in assuming, without any discussion nor reference to any authority, that the objective good faith requirement under § 548(c) is applicable to the determination of the claim for recission and "reasonably equivalent value" under § 548(a)(2)(A).

6. The bankruptcy court, taking judicial notice of the file, noted that McKay filed an amended proof of claim in the amount of $164,000 (his total investment less amount of the M&L checks cashed by him). The bankruptcy court allowed the filing of th amended proof, applying the principle that amendments to proofs of claim should be freely permitted. *See Unioil v. Elledge (In re Unioil, Inc.)*, 962 F.2d 988, 992-93 (10th Cir. 1992).

agree with the bankruptcy court that the issue is not what McKay stated that M&L owed him but, whether, at the time he made his investments, he had a right to restitution. Applying the law as stated in *In re United Energy Corp.*, 944 F.2d at 596, the bankruptcy court correctly concluded that McKay had a right to restitution as soon as he made his investments in M&L.

Accordingly, I affirm the bankruptcy court's ruling that McKay gave M&L "reasonably equivalent value" within the meaning of 11 U.S.C. § 548(a)(2).

IV. *Conclusion*

For the reasons stated above, the bankruptcy court's judgement is AFFIRMED.

Dated this 9th day of February, 1994 at Denver, Colorado

JOHN L. KANE, JR.

U.S. SENIOR DISTRICT COURT JUDGE

UNITED STATES COURT OF APPEALS
TENTH CIRCUIT

In re: M&L BUSINESS MACHINE COMPANY, INC.,	)	Nos. 94-1087 94-1097
Debtor.	)	
CHRISTINE J. JOBIN, Trustee of the Estate of M&L Business Machine Company, Inc.,	)	
Plaintiff-Appellee/ Cross-Appellant,	)	
v.	)	
PERRY S. McKAY,	)	
Defendant-Appellant/ Cross-Appellee.	)	

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO
(D.C. No. 93-K-1321)

Before KELLY, SETH*, and HENRY, Circuit Judges.

HENRY, Circuit Judge.

This appeal concerns the investments made by the appellant Perry S. McKay in a pyramid or "Ponzi" scheme run by the

* The late Honorable Oliver Seth, Senior Judge, United States Court of Appeals for the Tenth Circuit, heard oral argument in this case but did not participate in the final decision.

debtor in bankruptcy, M&L Business Machine Company, Inc. ("M&L"). The appellee Christine J. Jobin, the bankruptcy trustee for M&L, brought an adversary proceeding against Mr. McKay seeking to recover a total of $43,500 in payments made to him in the ninety day period preceding the filing of the bankruptcy petition. Ms. Jobin argued that, under the Bankruptcy Code, the $43,500 paid to Mr. McKay was avoidable for several reasons and that the money should be returned to the bankruptcy estate for distribution to all creditors. In response, Mr. McKay argued that the payments constituted returns of a good faith investment for which M&L obtained reasonably equivalent value, that the payments were made in the ordinary course of business, and that, as a result, the trustee was not entitled to recover them.

After the resolution of cross-motions for summary judgment and a trial, the bankruptcy court concluded that the trustee was entitled to recover $22,000.00 from Mr. McKay under 11 U.S.C. § 547(b), which authorizes the avoidance of transfers through which a transferee obtains more than he or she would have received in a chapter 7 liquidation proceeding. The court also held that the trustee was entitled to recover the entire $43,500 from Mr. McKay under 11 U.S.C. § 548(a)(1) as transfers made with the intent to hinder or defraud creditors. However, the court rejected the trustee's claim under 11 U.S.C. § 548(a)(2), which concerns transfers for which the debtor receives less than reasonably equivalent value. The effect of the bankruptcy court's rulings was a $22,000 judgment in favor of the trustee on the § 547(b) claim, and a judgment of $43,500 in favor of the trustee on the § 548(a)(1) claim. The district court affirmed the bankruptcy court's decision in all respects. *See Jobin v. McKay (In re M&L Business Mach. Co.)*, 164 B.R. 657 (D.Colo. 1994).

Mr. McKay now challenges the district court's affirmance of the bankruptcy court's entry of judgment in favor of the trustee on her § 547(b) and § 548(a)(1) claims. In her cross-appeal, the trustee contends that the bankruptcy and district courts erred in rejecting her claim under § 548(a)(2). For the reasons set forth below, we affirm the decision of the district court.

I. BACKGROUND

In the mid-1980s, officers of the debtor M&L began running a Ponzi scheme.[1] Using the company's legitimate operations as a computer sales and leasing company as a front, the M&L officers solicited investments by promising extremely high rates of return. Upon receiving money from investors, M&L issued promissory notes and paid the promised sums with postdated checks drawn on company accounts.

From June through September 1990, Mr. McKay invested a total of $207,500 in M&L on varying terms. He made an initial investment of $100,000 on June 19, 1990, receiving an unsecured promissory note offering a return of ten percent per month ($10,000) over a two year period. A week later, he

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1. We have defined a Ponzi scheme as

> an investment scheme in which returns to investors are not financed through the success of the underlying business venture, but are taken from principal sums of newly attracted investments. Typically, investors are promised large returns for their investments. Initial investors are actually paid the promised returns, which attract additional investors.

Sender v. Heggland Family Trust (In re Hedged-Invs. Assocs., Inc.), 48 F.3d 470, 471 n. 2 (10th Cir. 1995) (citing *Merrill v. Abbott (In re Ind. Clearing House Co.)*, 41 B.R. 985, 994 n. 12 (Bankr.D.Utah 1984), *aff'd in part and rev'd in part*, 62 B.R. 118 (D.Utah 1986)).

invested an additional $7,500 on the same terms. Finally, on September 7, 1990, and again on September 10, 1990, Mr. McKay invested $50,000 in M&L. On the latter two investments, M&L promised Mr. McKay a return of nine percent per week ($4,000). At the time of each of his investments, Mr. McKay received postdated checks. He deposited nine of them, totaling $43,500.

On October 1, 1990, M&L filed a petition under chapter 7 of the Bankruptcy Code. The bankruptcy court converted the case to chapter 11 and appointed Ms. Jobin as trustee. After the Ponzi scheme was discovered, the trustee converted the case back to chapter 7 and filed adversary proceedings against M&L investors in which she sought to recover payments made by M&L prior to the bankruptcy petition. She filed the instant adversary proceeding against Mr. McKay in September 1992 and asserted claims to recover the $43,500 under the preference, fraudulent transfer, and post-petition transaction provisions of the Bankruptcy Code. *See* 11 U.S.C. §§ 547, 548, and 549.

Mr. McKay and the trustee filed motions for summary judgment, which the bankruptcy court granted in part and denied in part. The court ruled that the trustee was entitled to recover $22,000 from Mr. McKay as an avoidable preference under 11 U.S.C. 547(b).[2] The court rejected Mr. McKay's

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2. As to the other $21,500 in payments from M&L, the court observed that, after he received them, Mr. McKay invested an additional $100,000 (i.e. the two $50,000 investments that he made in September 1990). Noting that, under 11 U.S.C. § 547(c)(4), the "new value" exception, the trustee may not avoid an otherwise preferential transfer if the transferee gives "new value" to the debtor after the transfer, the court ruled that the trustee could not recover the first four payments from M&L (totaling $ 21,500) under § 547. The trustee

argument that the transfers from M&L had been made "in the ordinary course of business" and therefore were not subject to avoidance in light of § 547(c)(2). Additionally, the court found that although the trustee had established the elements of an avoidable transfer "to hinder, delay, or defraud" creditors under § 548(a)(1), there were controverted issues of material fact as to whether Mr. McKay had received the payments from M&L "in good faith," as that term is used in § 548(c), such that he could defeat the § 548(a)(1) claim. Finally, the court concluded that there were unresolved factual issues as to whether M&L had received "reasonably equivalent value" for the transfers to Mr. McKay and that, as a result, summary judgment was also not warranted on the trustee's claim to avoid the transfers under § 548(a)(2).

After denying summary judgment on the § 548(a)(1) and 548(a)(2) claims, the bankruptcy court heard evidence concerning the circumstances surrounding Mr. McKay's investments in M&L. The evidence established that Mr. McKay had substantial experience in financial matters. In particular, he studied business administration in college and operated a profitable construction business in California. At the time of the bankruptcy proceedings, Mr. McKay was the co-trustee of a family trust holding over $3,000,000 in assets. He operated an industrial park in Golden, Colorado, a commercial real estate

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(fn. 2 cont'd)
did not challenge this conclusion regarding the § 547(c)(4) exception in the appeal to the district court, and she has not done so in this appeal. However, because of our ultimate conclusion that the trustee may recover the entire $43,500 (including the $21,500 covered by the "new value" exception) under § 548(a)(1), the applicability of the exception is of little practical benefit to Mr. McKay.

business, and a farming and ranching business. When he began investing in M. & L, Mr. McKay's portfolio included stocks and bonds - which he traded through several brokers - mutual funds, land, and promissory notes. He subscribed to several investment publications.

Mr. McKay testified that he learned of M&L though Dr. Alec Tsoucatos, an economics professor and former college president who informed him of the extremely high rates of return that M&L was offering and reported that he had profitably invested in M&L over the last five years. Mr. McKay acknowledged that shortly after his first payment to M&L, he learned that Dr. Tsoucatos, although not representing himself to be a broker, had received a commission for convincing him to invest.

After speaking with Dr. Tsoucatos, Mr. McKay visited M&L's corporate offices and spoke with two of its officers. In response to his inquiries about M&L's offering such high rates of return, the M&L officers stated that investors' cash payments allowed the company to obtain computer equipment at very low prices and then negotiate extremely profitable contracts with its customers. The officers reported that M&L had obtained contracts to provide equipment to a California school district and to several Fortune 500 companies. However, they said, concerns about confidentiality precluded them from disclosing the terms of specific contracts. The M&L officers also informed Mr. McKay that the company's use of private investors to provide financing allowed them to negotiate contracts more quickly, without the constraints imposed by conventional lenders. However, the officers also stated that the majority of their financing was obtained through conventional lenders.

Mr. McKay also testified to the bankruptcy court that, before investing in M&L, he reviewed audited financial statements (for 1988, 1989, and part of 1990) that M&L officers provided. He also reviewed sales projections for 1990 and biographical sketches of two of M&L's officers. The sketches indicated that neither officer had significant financial experience. Additionally, Mr. McKay did not attempt to verify any of the information in the financial statements. He neither examined any of the purported contracts with M&L customers nor attempted to contact any of the conventional lenders that the M&L officers had reported to be the source of most of the company's financing.

In his testimony before the bankruptcy court, Mr. McKay acknowledged that the first check that he received from M&L was returned for uncollected funds. After receiving notice of the returned check, Mr. McKay contacted a bank officer, who informed him that the matter would be discussed with M&L's president. Subsequently, Mr. McKay spoke to M&L's president, who assured him that the problem had been corrected. The check cleared after it was deposited a second time. Dr. Tsoucatos then advised Mr. McKay not to deposit M&L's checks until five days after the date on each check. Mr. McKay followed this advice and had no further difficulty in depositing M&L's checks.

During the bankruptcy proceedings, the trustee also introduced testimony from Mr. Ken Wester, a goldsmith and gemologist who had been solicited to invest in M&L but had declined. Mr. Wester had considerably less financial experience than Mr. McKay, but he explained that he refused to invest because he was suspicious of the extremely high rates of return.

After hearing the evidence, the bankruptcy court issued findings of fact and conclusions of law. The court ruled that Mr. McKay had failed to demonstrate that the transfers from M&L were taken in good faith under § 548(c). As a result, it found that the trustee was entitled to avoid all of the challenged transfers under § 548(a)(1), but not under 548(a)(2). With regard to the § 548(a)(2) claim, the court reasoned that because M&L had received reasonably equivalent value for its payments to Mr. McKay, judgment should be entered in favor of Mr. McKay.

The district court affirmed the bankruptcy court's summary judgment rulings, findings of fact, and conclusions of law in all respects. *See Jobin*, 164 B.R. at 661-668. On appeal to this court, Mr. McKay advances the following arguments: (1) that the bankruptcy and district courts erred in applying an objective standard of good faith under § 548(c); (2) that even under an objective standard, the evidence presented to the bankruptcy court established that he received the payments from M&L in good faith; and (3) that the courts erred in concluding that the transfers from M&L were not made in the ordinary course of business under § 547(c)(2). In her cross appeal, the trustee argues that the courts erred in rejecting her claim to avoid the transfers under § 548(a)(2).

II. DISCUSSION

A. *The objective standard for determining good faith is proper under 11 U.S.C. § 548(c).*

Mr. McKay first argues that the bankruptcy and district courts erred in concluding that he did not receive the transfers from M&L in good faith and in thereby rejecting his defense to the trustee's § 548 claims. He maintains that both courts

erroneously applied an objective standard of good faith, under which "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." *Jobin*, 164 B.R. at 661 (quoting *Hayes v. Palm Seedlings Partners-A (In re Agric. Research & Technology Group, Inc.)*, 916 F.2d 528, 536 (9th Cir. 1990)). According to Mr. McKay, the proper measure of good faith under § 548(c) is subjective – "a transferee does not lack 'good faith' unless he has some actual knowledge of the fraud." Aplt. Brief at 26. This argument raises a legal question regarding the proper interpretation of the Bankruptcy Code and is therefore subject to de novo review. *See Dalton Dev. Project v. Unsecured Creditors Comm. (In re Unioil)*, 948 F.2d 678, 681 (10th Cir. 1991) (Although "[a] bankruptcy court's factual determinations will not be disturbed on appeal absent the most cogent reasons appearing in the record," conclusions of law may be reviewed de novo. (internal quotation and citation omitted)).

We begin our analysis with the language of the Bankruptcy Code. Section 548(a)(1) provides that the trustee may avoid transfers of the debtor's property made within one year before the filing of the bankruptcy petition if the debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became...indebted." Section 548(a)(2) authorizes the trustee to avoid transfers on somewhat different grounds. If the debtor "received less than reasonably equivalent value" in exchange for a transfer of the debtor's property, the trustee may avoid the

transfer if several additional elements are established. 11 U.S.C. § 548(a)(2).[3]

Section 548(c) provides a defense for individuals to whom the debtor's property is transferred:

> Except to the extent that a transfer or obligation voidable under this section is voidable under section 544, 545, or 547 of this title, a transferee or obligee of such a transfer or obligation that *takes for value and in good faith* has a lien on or may retain any interest transferred or may enforce any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

11 U.S.C. § 548(c) (emphasis supplied).

As the parties note, the Bankruptcy Code does not define "good faith." "Likewise, the legislative history related to section 548(c) never defines, and scarcely addresses, good faith." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557 n. 20. (Bankr.N.D.Ill. 1994) (citing S.Rep. No.989, 95th Cong., 2d Sess. 89-90 (1978), H.R.Rep. No. 595, 95th Cong., 1st Sess. 375

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3. 11 U.S.C. § 548(a)(2) states that the trustee may avoid transfers made within a year of the filing of the bankruptcy petition if she establishes that the debtor:

> (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
> (B)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
> (ii)was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

(1977)). As a result, courts applying § 548(c) have generally refused to formulate precise definitions. *See, e.g., In re Agric. Research & Technology Group*, 916 F.2d at 536 ("Courts have been candid in acknowledging that good faith 'is not susceptible of precise definition.'")(quoting *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 984 (1st Cir. 1983); *In re Telesphere*, 179 B.R. at 557 (noting that "there is no clear source of interpretive guidance" in construing the term). In analyzing § 548(c), one leading commentator has concluded that "[t]he unpredictable circumstances in which the courts may find its presence or absence render any definition of 'good faith' inadequate, if not unwise." 4 *Collier on Bankruptcy* ¶ 548.07[2] at 548-72 (Lawrence P. King ed., 15th ed. 1996).

Nevertheless, contrary to Mr. McKay's contention, "good faith" has frequently been construed to include an objective component. After noting that "[g]ood faith is an intangible and abstract quantity with no technical meaning," *Black's Law Dictionary* states that the term includes not only "honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage" but also "*freedom from knowledge of circumstances which ought to put the holder on inquiry.*" *Black's Law Dictionary* at 693 (6th ed. 1990) (emphasis supplied). Prominent bankruptcy scholars agree: "[T]he presence of any circumstance placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith unless investigation actually disclosed no reason to suspect financial embarrassment." 4 *Collier on Bankruptcy, supra*, ¶ 548.07 at 548-73.

The Eighth Circuit has recently followed this objective approach in determining good faith under § 548(c), holding

that "a transferee does not act in good faith when he has sufficient knowledge to place him on inquiry notice of the debtor's possible insolvency." *See Brown v. Third Nat. Bank (In re Sherman)*, 67 F.3d 1348, 1355 (8th Cir. 1995) (citing *Armstrong v. Ketterling (In re Anchorage Marina, Inc.)*, 93 B.R. 686, 693 (Bankr.D.N.D. 1988); 4 *Collier on Bankruptcy, supra*, ¶ 548.07 at 548-72 to 73). The *Sherman* court concluded that the transferee's knowledge of the debtors' substantial debts, of their delinquent mortgage payments, of a bank's plan to file foreclosure proceedings against them, and of a pending lawsuit placed the transferee on inquiry notice that the transfer of the debtors' property was not made in good faith under § 548(c). 67 F.3d at 1355-56. Similarly, in *In re Agric. Research & Technology Group*, the Ninth Circuit relied on several Supreme Court decisions construing "good faith" in other contexts to conclude that "courts look to what the transferee objectively 'knew or should have known' in questions of good faith, rather than examining what the transferee actually knew from a subjective standpoint."[4] Significantly, the majority of bankruptcy courts construing "good faith," as it is used in § 548(c), have followed

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4. Although the question before the Ninth Circuit was the proper interpretation of "good faith" under a section of Hawaii's Fraudulent Conveyance Act, Haw.Rev.Stat. § 651C-8(d), the court referred to 11 U.S.C. § 548(c) as "the equivalent" of the Hawaii statute. *See In re Agric. Research & Technology Group*, 916 F.2d at 535. Moreover, in adopting the objective standard for determining good faith, the Ninth Circuit relied on bankruptcy court decisions construing § 548(c). *See id.* at 535-36 (citing *McColley v. Rosenberg (In re Candor Diamond Corp.)*, 76 B.R. 342, 351 (Bankr.S.D.N.Y. 1987); *Consumers Credit Union v. Widett (In re Health Gourmet, Inc.)*, 29 B.R. 673, 677 (Bankr.D.Mass. 1983); *Sanitary Ice Vending Co., Inc. v. Harris (In re Polar Chips Int'l, Inc.)*, 18 B.R. 480, 484 (Bankr.S.D.Fla. 1982)).

the Eighth and Ninth Circuits, holding that a transferee who reasonably should have known of a debtor's insolvency or of the fraudulent intent underlying the transfer is not entitled to the § 548(c) good faith defense. *See, e.g., In re Anchorage Marina,* 93 B.R. at 693; *Walker v. Littleton (In re Littleton),* 82 B.R. 640, 644 (Bankr.S.D.Ga. 1988), *rev'd on other grounds,* 888 F.2d 90 (11th Cir. 1989); *Williams v. Kidder Skis Int'l (In re Fitzpatrick),* 73 B.R. 655, 658 (Bankr.W.D.Mo.), *aff'd in part and rev'd in part,* 60 B.R. 808 (W.D.Mo. 1985); *In re Polar Chips Int'l,* 18 B.R. at 484.

In arguing that these decisions should not be followed and that good faith should be measured subjectively, Mr. McKay invokes this circuit's decision in *Richards v. Platte Valley Bank,* 866 F.2d 1576 (10th Cir.1989), two Fourth Circuit decisions, the analysis of several bankruptcy courts, and the definitions of good faith under the Uniform Commercial Code and various state laws concerning fraudulent conveyances. However, none of these authorities establishes that the objective measure of good faith applied by the bankruptcy and district courts is improper.

In *Richards,* we construed a provision of Colorado's version of the Uniform Fiduciaries Act, Colo.Rev.Stat. § 15-1-109, that imposed liability on banks paying checks written by fiduciaries when "paying the check amounts to bad faith." *Richards,* 866 F.2d at 1579 n. 2 (quoting Colo.Rev.Stat. § 15-1-109). We observed that although the statute did not define "bad faith," it defined good faith as "'a thing done 'honestly, whether it be done negligently or not.'" *Id.* at 1582 (quoting Uniform Fiduciaries Act, § 1(2), 7A U.L.A. 396 (1985)). We considered that definition in concluding that, under the Colorado statute, the mere failure to make inquiry, even though there are suspicious circumstances, does not constitute bad faith –

"unless the facts and circumstances are so cogent and obvious that to remain passive would amount to deliberate desire to evade knowledge because of a belief or fear that inquiry would disclose a defect in the transaction." *Id.* at 1583 (citations omitted).

Richards clearly does not address the circumstances now before us in this adversary proceeding under the Bankruptcy Code. As noted above, unlike the Uniform Fiduciaries Act, § 548(c) of the Bankruptcy Code does not define good faith in terms of knowledge and does not expressly exclude consideration of negligence. Moreover, the *Richards* decision is based in part on consideration of the purpose of the Uniform Fiduciary Act – the need for uniform rules "to take the place of diverse and conflicting rules that had grown up concerning constructive notice of breach of fiduciary obligations in order that commerce might proceed with as little hindrance as possible." *Id.* (quoting *Union Bank & Trust Co. v. Girard Trust Co.*, 307 Pa. 488, 161 A. 865, 870 (1932)). In the instant case – in which a bankruptcy trustee seeks to recover assets for the benefit of all creditors of a Ponzi scheme – the need for a good faith standard that removes hindrances to commerce is not the paramount concern that it was in *Richards*. *See Gill v. Winn (In re Perma Pac. Properties, Inc.)*, 983 F.2d 964, 968 (10th Cir. 1992) ("It is the ultimate aim of the preference law in the Bankruptcy Code to insure that all creditors receive an equal distribution from the available assets of the debtor.").

As to the other authorities on which Mr. McKay relies, we agree with the district court that none of them expressly addresses the issue of whether the determination of good faith under § 548(c) has an objective component. (*See Jobin*, 164 B.R. at 661-62. *Smith v. Mixon*, 788 F.2d 229 (4th Cir. 1986), the more recent of the Fourth Circuit cases that Mr. McKay cites,

interprets a provision of the Bankruptcy Code, 11 U.S.C. § 550(b)(1), which establishes a defense to a trustee's avoidance actions under 11 U.S.C. § 550(a)(2) for "any immediate or mediate transferee of such initial transferee." Section 550(b)(1) provides that the trustee may not recover from these transferees if they "take for value ... in good faith, *and without knowledge* of the voidability of the transfer avoided." 11 U.S.C. § 550(b)(1) (emphasis supplied). In construing this section, the *Smith* court focused on the use of the term "knowledge" and concluded that that term referred to actual notice and not constructive notice. *Smith*, 788 F.2d at 232. In this case, because Mr. McKay received the disputed funds directly from the debtor, M&L, he was not an "immediate or mediate transferee of [an] initial transferee," 11 U.S.C. § 550(b)(1). The reasoning of *Smith* is therefore inapplicable.

The earlier Fourth Circuit decision on which Mr. McKay relies, *Gilmer v. Woodson*, 332 F.2d 541(4th Cir.), *cert. denied* 379 U.S. 834, 85 S.Ct. 67, 13 L.Ed.2d 42 (1964), is also based on a statute not at issue here - section 67(d)(2) of the Bankruptcy Act. Construing that section, the *Gilmer* court stated that "good faith cannot be said to be lacking unless the transferee knowingly participated in the debtor-transferor's purpose to defeat other creditors or lacked good faith in valuing the property exchanged." *Gilmer*, 332 F.2d at 547. However, the court did not expressly hold that good faith must always be subjectively measured under section 67(d) of the Bankruptcy Act. Moreover, in reversing the district court's finding of a lack of good faith, the *Gilmer* court considered several objective factors - the value of the antecedent debt and the value of the security received. *See Id.* Therefore, *Gilmer* also does not establish that good faith under § 548(c) must be measured subjectively.

As to the decisions of bankruptcy courts, Mr. McKay relies primarily on *Merrill v. Abbott (In re Indep. Clearing House Co.)*, 77 B.R. 843 (D.Utah 1987), and *Practical Inv. Corp. v. Rellen (In re Practical Inv. Corp.)*, 95 B.R. 935 (Bankr.E.D.Va. 1989). However, as the district court noted, neither case held that good faith under § 548(c) must always be measured subjectively. In particular, although at one point the *Independent Clearing House* court referred to good faith as "a subjective question," 77 B.R. at 862, the court also noted that the presence of circumstances placing the transferee on inquiry as to the debtor's insolvency may deprive him of the good faith defense, *id.* (citing 4 *Collier on Bankruptcy, supra*, ¶ 548.07[2] at 548-[72]). Moreover, the *Independent Clearing House* court explained (albeit in a mixed anatomical metaphor) the determination of good faith in a manner that emphasized objective factors: "The test is whether the transaction in question bears the earmarks of an arms length bargain." *Id.* Similarly, in *In re Practical Investment*, the court focused on the particular facts before it in concluding that a transferee was entitled to the good faith defense and did not expressly hold that a subjective test was required. 95 B.R. at 942–45.

Finally, we are not persuaded by Mr. McKay's argument that the definitions of good faith under the Uniform Commercial Code and state fraudulent conveyance laws should be adopted in interpreting § 548(c). Many of these provisions contain language different than the language used in § 548(c) and, like the Uniform Fiduciaries Act, which we considered in *Richards*, 866 F.2d at 1583, involve policy concerns not applicable here. *See, e.g., Territorial Sav. & Loan Ass'n v. Baird*, 781 P.2d 452, 461 (Utah App. 1989) (referring to the definition of "good faith" set forth in Utah Code Ann. § 70A-1-201(19) (1989) - "honesty in fact in the conduct or transaction concerned");

Money Mart Check Cashing Ctr., Inc. v. Epicycle Corp. 667 P.2d 1372, 1373 (Colo. 1983) (noting that "[t]he drafters of the Uniform Commercial Code intended that this standard [of good faith] be a subjective one"). Significantly, none of the decisions cited by Mr. McKay concern an investor in a Ponzi scheme who had notice of the kind of suspicious circumstances that surrounded M&L. In construing the term "good faith," as it is used in §548(c), we find the decisions of the Eighth and Ninth Circuits and the majority of bankruptcy courts more persuasive than the authorities on which Mr. McKay relies.

Accordingly, we conclude that the bankruptcy court and the district court properly held that good faith under § 548(c) should be measured objectively and that "if the circumstances would place a reasonable person on inquiry of a debtor's fraudulent purpose, and a *diligent* inquiry would have discovered the fraudulent purpose, then the transfer is fraudulent." *Jobin*, 164 B.R. at 661 (quoting *Agric. Research & Technology Group*, 916 F.2d at 536).

B. Evidence of a Lack of Good Faith

Mr. McKay also argues that, even under an objective standard, the bankruptcy and district courts erred in concluding that his receipt of the $43,500 was not "in good faith" under § 548(c). Resolution of this issue requires a determination of whether the facts satisfy the proper legal standard, a mixed question of law and fact. *See Clark v. Security Pac. Business Credit, Inc. (In re Wes Dor, Inc.)*, 996 F.2d 237, 241 (10th Cir. 1993). In these circumstances, because the question of good faith is primarily factual, we will review the findings of the bankruptcy court for clear error. *See id.* at 242 (applying the clearly erroneous standard to the district court's determination of value under § 548(c)); *see also Acequia, Inc. v. Clinton (In re*

Acequia, Inc.), 34 F.3d 800, 805 (9th Cir. 1994); *In re Roco*, 701 F.2d at 981–82.

In arguing that he received the $43,500 from M&L in good faith, Mr. McKay notes that he invested in M&L on the recommendation of Dr. Tsoucatos, a former economics professor, and that he received assurances about the financial soundness of the company from M&L's president after the first check was returned. As further indicators of good faith, Mr. McKay also points to his visit to M&L's offices, the explanations of the high rates of return provided by M&L officials, and his review of company financial statements.

Under § 548(c), Mr. McKay has the burden of establishing good faith. *See Agric. Research & Technology Group*, 916 F.2d at 535; *In re Candor Diamond Corp.*, 76 B.R. at 351, 4 *Collier on Bankruptcy, supra*, ¶ 548.10 at 548-129. Upon review of the record, we agree with the district court that the bankruptcy court's finding that Mr. McKay failed to establish good faith under the objective standard of § 548(c) was not clearly erroneous. The factors supporting this conclusion have been persuasively outlined by the district court: Mr. McKay's experience as an investor; promised rates of return greatly exceeding the market rate (120% per year on two investments and 468% on the two other investments); an implausible explanation by M&L officials as to how the company could pay these extremely high rates; M&L's use of postdated checks to pay investors; Dr. Tsoucatos's disclosure that he received a commission for finding investors for M&L; and the fact that the company's first check to Mr. McKay was returned. *See Jobin*, 164 B.R. at 662-63. In light of all of these circumstances, it was not clearly erroneous for the bankruptcy court to conclude that a reasonably prudent investor in Mr. McKay's position should

have known of M&L's fraudulent intent and impending insolvency and that he was therefore not entitled to the good faith defense established by § 548(c).

C. The "Ordinary Course of Business" Defense under §547(c)(2)

Mr. McKay also challenges the conclusion of the bankruptcy and district courts that the transfers from M&L were not made "in the ordinary course of... business or financial affairs," 11 U.S.C. § 547(c)(2), and that, as a result, the trustee was entitled to avoid the transfers under § 547(b). On this factual question, we must accept the conclusions of the bankruptcy court unless they are clearly erroneous. *Clark v. Balcor Real Estate Fin., Inc. (In re Meridith Hoffman Partners)*, 12 F.3d (10th Cir. 1993), *cert. denied*, __U.S.__, 114 S.Ct. 2677, 129 L.Ed.2d 812 (1994).

Under § 547(b), the trustee may avoid transfers of property of the debtor made within ninety days of the filing of the bankruptcy petition if she proves that the transfer was made: (1) for the benefit of a creditor; (2) in satisfaction of an antecedent debt; (3) while the debtor was insolvent; and (4) such that it enabled the creditor to receive more than he would have received in a chapter 7 liquidation proceeding. 11 U.S.C. § 547(b)(1)-(5).[5] Section 547(c)(2) establishes a defense as to transfers made in the ordinary course of business:

> (c) The trustee may not avoid under this section a transfer-
>
> (2) to the extent that such transfer was-

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5. Under § 547(b), the trustee may also avoid transfers made within a year of the filing of the bankruptcy petition if she also establishes that the transferee was an "insider." *See* 11 U.S.C. § 547(b)(4)(B).

> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
> (C) made according to ordinary business terms[.]

11 U.S.C. § 547(c)(2). The transferee has the burden of proving this defense. *In re Meridith Hoffman Partners*, 12 F.3d at 1553. Additionally, the defense should be narrowly construed. *J.P. Fyfe, Inc. v. Bradco Supply Corp.*, 96 B.R. 474, 476 (D.N.J. 1988), *affd*, 891 F.2d 66 (3d Cir. 1989); *First Software Corp. v. Curtis Mfg. Co. (In re First Software Corp.)*, 81 B.R. 211, 213 (Bankr.D.Mass. 1988); *Waldschmidt v. Ranier (In re Fulghum Constr. Corp.)*, 78 B.R. 146, 150 (M.D.Tenn. 1987), *rev'd on other grounds*, 872 F.2d 739 (6th Cir. 1989).

In affirming the conclusion of the bankruptcy court that Mr. McKay had failed to establish the ordinary course of business defense, the district court focused on § 547(c)(2)(C)'s requirement that the transfer be made according to ordinary business terms. *See Jobin*, 164 B.R. at 664-65. In applying § 547(c)(2), we have taken the same approach. *See In re Meridith Hoffman Partners*, 12 F.3d at 1553 ("Because we conclude that the payments were not made according to ordinary business terms, we do not discuss whether they meet the other two requirements."). Accordingly, we will address the "ordinary business terms" element of the § 547(c)(2) defense.

In *In re Meridith Hoffman Partners*, we concluded that "ordinary business terms" under § 547(c)(2) "are those used in 'normal financing relations,': the kinds of terms that creditors and debtors use in ordinary circumstances, when debtors are healthy." 12 F.3d at 1553. We arrived at this definition by considering the general purpose of the § 547(c)(2) defense – "to

leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy." *Id.* (quoting, S.Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), 1978 U.S.C.C.A.N. 5787, 5874).

Although several courts have concluded that transfers by a debtor engaged in a Ponzi scheme do not, as a matter of law, involve ordinary business terms, *see, e.g., Henderson v. Buchanan,* 985 F.2d 1021, 1025 (9th Cir. 1993); *In re Taubman,* 160 B.R. 964, 971 (Bankr.S.D.Ohio 1993), we have chosen a middle ground. In *Sender v. Heggland Family Trust (In re Hedged-Invs. Assocs., Inc.),* 48 F.3d 470, 476 (10th Cir. 1995), we rejected "the sweeping rule that § 547(c)(2) has absolutely no application in the context of a Ponzi scheme." Instead, we stated that because investment companies do not ordinarily pay fraudulent profits to early investors, the § 547(c)(2) defense is inapplicable to payments to investors in a Ponzi scheme. *Id.* However, we also noted that payments to non-investment creditors could be made according to ordinary business terms and in the ordinary course of business such that these investors are entitled to the § 547(c)(2) defense. *Id.* ("If, for instance, a Ponzi scheme uses telephone services, is billed for that service, and pays the phone company, disallowing the avoidance of that payment following a bankruptcy petition is consistent with the purposes of § 547.").

In the instant case, it is undisputed that Mr. McKay is an investment creditor of a Ponzi scheme. The rule we formulated in *In re Hedged-Investments* is directly applicable, and the bankruptcy court did not clearly err in concluding that payments from M&L to Mr. McKay were not made according to

ordinary business terms under § 547(c)(2)(C). The bankruptcy court and the district court properly rejected Mr. McKay's ordinary course of business defense to the trustee's § 547 claim.

D. Reasonably Equivalent Value Under § 548(a)(2)

In her cross-appeal, the trustee argues that the bankruptcy court and the district court erred in concluding that she was not entitled to avoid the transfers from M&L to Mr. McKay under § 548(a)(2). We find no error in the analysis of the bankruptcy and district courts.

Section 548(a)(2) provides that the trustee may avoid transfers of the debtor's property made within one year of the bankruptcy petition if the debtor:

> (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (B)(i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (ii) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

11 U.S.C. § 548(a)(2). Section 548(d)(2)(A) defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor." As the district court noted, the Bankruptcy Code does not define the term "antecedent debt," but it does define "debt" as "liability on a claim." *See Jobin*, 164 B.R. at 666 (citing 11 U.S.C. § 101(12)). "Claim" is defined broadly as the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent,

matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured," and as the "right to an equitable remedy for a breach of performance." 11 U.S.C. § 101(5).

Both the bankruptcy court and the district court rejected the trustee's § 548(a)(2) claim on the grounds that Mr. McKay had given "reasonably equivalent value" to M&L. According to both courts, the value given to M&L was the reduction of Mr. McKay's claim for restitution against M&L. As the bankruptcy court explained, "[I]t is not disputed that [Mr. McKay] invested the total sum of $207,500 into M&L and was only able to cash checks totaling $43,500.00. That is[,] [Mr. McKay] lost, on an out-of-pocket basis, the sum of $164,000.00 and still has a restitution right to same." Aplt.App. vol. II at 542. Thus, according to the bankruptcy and district courts, in paying $43,500 to Mr. McKay, M&L received "reasonably equivalent value" in that Mr. McKay's claim for restitution as a defrauded investor was reduced by this amount.

The courts based their reasoning on two decisions: *Wyle v. Rider (In re United Energy Corp.)*, 944 F.2d 589, 596 (9th Cir. 1991) and *In re Independent Clearing House*, 77 B.R. at 857. Both decisions concluded that investors in fraudulent schemes had claims for restitution and rescission against the debtor and that, by reducing the amount of these claims, the debtors' payments provided reasonably equivalent value. *See In re United Energy* 944 F.2d at 596 (noting that investors in a fraudulent scheme clearly had claims for rescission and restitution . . . regardless of whether there existed a contractual right to the return of principal); *In re Independent Clearing House*, 77 B.R. at 857 ("From the time a defendant entrusted his money to the debtors, he had a claim against the debtors for the return of his money. We believe that the Code's definition of 'debt' and its

related terms is broad enough to cover the debtors' obligation to return a defendant's principal undertaking, whether that obligation was based on the contract between the debtors and the defendant or was based on the defendant's right to restitution.").

In challenging the rejection of her § 548(a)(2) claim, the trustee relies on the bankruptcy court's finding that Mr. McKay lacked good faith under § 548(c). She argues that, because Mr. McKay lacked good faith, he did not have a colorable restitution claim against M&L, and, as a result, M&L's payments to him did not provide M&L with "reasonably equivalent value" by reducing such a claim. She also argues that the bankruptcy and district courts improperly applied two standards of good faith – an objective one under § 548(c) and a subjective one under § 548(a)(2). She maintains that the objective standard should be applied under both subsections and that, under this objective standard, she is entitled to avoid the transfers under § 548(a)(2).

Contrary to the trustee's argument, the language of § 548(a)(2) and § 548(c) does not require application of the same standard. Although § 548(c) uses the term "good faith" § 548(a)(2) does not. Instead, § 548(a)(2) refers to "value." Because the Bankruptcy Code's definition of "value" includes "satisfaction of an antecedent debt" and because the Code's definition of "debt" includes "liability on a claim," analysis of the trustees § 548(a)(2) claim requires us to determine whether Mr. McKay has a claim against M&L and, if so, whether M&L's payments to him reduced that claim – thereby providing "reasonably equivalent value."

In making these determinations, we apply Colorado law. *See Landsing Diversified Properties-II v. First Nat'l Bank & Trust*

Co. (In re W. Real Estate, Inc.), 922 F.2d 592, 595 (10th Cir. 1990), *modified sub nom., Abel v. West*, 932 F.2d 898 (1991); *Flavor Dry, Inc. v. Lines (In re James E. O'Connell Co.)*, 799 F.2d 1258, 1260 (9th Cir. 1986). Additionally, we must consider the following factual findings of the bankruptcy court regarding Mr. McKay's state of mind - which the trustee has not challenged in her cross-appeal:

> This conclusion regarding objective "bad faith," (more accurately lack of good faith) should not be construed as a determination by this Court of malicious intent, malevolence, or nefarious scheming by McKay or of a lack of credibility. The Court does not find that he was malicious, malevolent, nefarious, or not credible. He simply did not invest in M&L and receive payments from M&L in a good faith manner as measured by an objective–not subjective standard.

Aplt.App. vol. II at 547. Accordingly, the question before us is whether an individual investor who should have known of a fraudulent scheme but did not have actual knowledge has a colorable restitution claim to recover his investment.

Upon review of the applicable law, we conclude that Mr. McKay has such a claim. One who has been fraudulently induced to enter into a contract may rescind the contract and recover the benefits that he has conferred on the party who has defrauded him. *See Western Cities Broadcasting v. Schueller* 849 P.2d 44, 48 (Colo. 1993) (en banc); *Trimble v. City & County of Denver*, 697 P.2d 716, 723-24 (Colo. 1985). Importantly:

> A suit in equity for rescission of a contract...does not necessarily fail because the party seeking rescission was unreasonable in relying upon the misrepresentation made by the other party. Even negligence on the part of the party seeking rescission will not bar equitable relief when the

misrepresentation was made intentionally by the other party.

Pacific Maxon, Inc. v. Wilson, 96 Nev. 867, 619 P.2d 816, 817 (1980).

Colorado courts have applied this principle to allow a party fraudulently induced to enter into a contract to recover the full amounts paid even when the defrauded party acted negligently and had inquiry notice of the fraud. For example, in *Enerwest, Inc. v. Dyco Petroleum Corp.*, 716 P.2d 1130, 1132 (Colo. App. 1986), the court concluded that a company that had entered into a contract to acquire an easement was entitled to "restitution of the full amount paid under the contract" because the parties purporting to convey the easement had fraudulently concealed the fact that they had previously conveyed the easement to a third party. The court observed that the defrauded parties' right to recover restitution was unaffected by the fact that they had inquiry notice of the prior conveyance. *Id; see also Loden v. Drake*, 881 P.2d 467, 469 (Colo. App. 1994) (noting that a party's failure to read certain provisions of a contract does not preclude restitution if the other party fraudulently concealed other contractual terms).

In this case, the evidence in the record indicates that Mr. McKay was fraudulently induced to invest in M&L. As a result, in light of the bankruptcy court's factual finding that he did not have actual knowledge of the fraud, Mr. McKay has a colorable claim to recover the amounts that he invested in M&L. The bankruptcy and district courts thus properly concluded that M&L's payments to Mr. McKay reduced the amount of this restitution claim, that M&L thereby received reasonably equivalent value for its payments to him, and that

the trustee was not entitled to avoid the transfers under § 548(a)(2).[6]

III. CONCLUSION

For the reasons set forth above, we therefore AFFIRM the decision of the district court in all respects.

---

6. In her cross-appeal, the trustee has also argued that the fact that Mr. McKay filed a proof of claim in the bankruptcy court for the entire amount that he invested in M&L ($212,500.00) and the fact that he did not state that this claim was for restitution establish that he does not have a restitution claim against M & L. We agree with the district court that this argument is not persuasive. "[T]he issue is not what McKay stated that M & L owed him but, whether, at the time he made his investments, he had a right to restitution." *Jobin*, 164 B.R. at 668. Moreover, Mr. McKay has filed an amended proof of claim for $164,000 - the sum of his investments in M & L minus the payments that he received. *See id.* at 668 n. 6.

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

In re: M&L BUSINESS MACHINE COMPANY, INC., Debtor,	)	
CHRISTINE J. JOBIN, Trustee of the Estate of M&L Business Machine Company, Inc.,	)	
Plaintiff-Appellee,	)	No. 94-1087
v.	)	
PERRY S. MCKAY	)	
Defendant-Appellant.	)	

ORDER

Entered July 16, 1996

Before KELLY and HENRY, Circuit Judges.

This matter comes on for consideration of appellant's petition for rehearing and suggestion for rehearing in banc.

Upon consideration whereof, the petition for rehearing is denied by the panel that rendered the decision.

In accordance with Rule 35(b), Federal Rules of Appellate Procedure, the suggestion for rehearing in banc was

transmitted to all of the judges of the court who are in regular active service. No member of the panel and no judge in regular active service on the court having requested that the court be polled on rehearing in banc, Rule 35, Federal Rules of Appellate Procedure, the suggestion for rehearing in banc is denied.

Entered for the Court
PATRICK FISHER, Clerk

Supreme Court, U.S.
FILED
NOV 12 1996
CLERK

No. 96-569

In The

Supreme Court of the United States

October Term, 1996

PERRY S. McKAY,

Petitioner,

v.

CHRISTINE J. JOBIN, Chapter 7 Trustee of the Bankruptcy Estate of M & L Business Machine Co., Inc.,

Respondent.

On Petition For Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED FOR REVIEW

1. Whether, in defense of a claim brought by a bankruptcy trustee under § 548(a)(1) of the Bankruptcy Code, a transferee who is an investor in a Ponzi scheme, will be found to lack good faith if the circumstances would place a reasonable person on notice of the debtor's fraudulent purpose, and a diligent inquiry would have discovered the fraudulent purpose.

2. Whether the ordinary course of business defense set forth in § 547(c)(2) of the Bankruptcy Code is available to an investor in a Ponzi scheme when the investor fails to present sufficient evidence to meet the requirements to such defense.

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STATUTES INVOLVED IN THE CASE

A. 11 U.S.C. § 547(c)(2):

(c) The trustee may not avoid under this section [11 U.S.C. § 547(b)] a transfer –

* * *

(2) to the extent that such transfer was –

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms[.]

B. 11 U.S.C. § 548(a)(1):

(a) The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one

year before the date of the filing of the petition, if the debtor voluntarily or involuntarily –

> (1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted[.]

C. 11 U.S.C. § 548(c):

Except to the extent that a transfer or obligation voidable under this section [11 U.S.C. § 548] is voidable under section 544, 545 or 547 of this title, a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred or may force any obligation incurred, as the case may be, to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation.

STATEMENT OF THE CASE

This case concerns a bankruptcy trustee's claims to avoid transfers made to an investor in a Ponzi scheme that was operated in Colorado from the mid-1980's through 1990. The Debtor, M&L Business Machine Co., Inc. ("M&L" or the "Debtor"), a Colorado corporation, filed a voluntary Chapter 7 petition in bankruptcy on October 1, 1990. The Chapter 7 case was immediately converted to a case under Chapter 11, but on December 18, 1990, the Respondent was appointed as the Chapter 11 bankruptcy trustee in the wake of serious allegations of

fraud on the part of the Debtor's principals. After a brief investigation, the Respondent determined that the Debtor had been operating a Ponzi scheme under the guise of a business and computer equipment sales and service company. The Respondent determined that the Debtor's inventory contained over 700 boxes of dirt and/or bricks, and not computers or business equipment. (Pet. App. 47-48). The Respondent requested the Court to convert the case to a case under Chapter 7 of the Bankruptcy Code, and the conversion was ordered on October 1, 1991. The Respondent is the duly appointed and acting Chapter 7 trustee under 11 U.S.C. § 702.

In 1992 and 1993, in furtherance of her statutory duties, the Respondent commenced approximately 540 adversary proceedings to avoid transfers of money to investors under § 547(b), §§ 548(a)(1) and (a)(2) and § 549 of the Bankruptcy Code. Of the approximately 540 adversary proceedings commenced, less than ten (10) proceeded to trial. Petitioner is one of the few defendants who proceeded to trial on the merits. Approximately 300 of the 1,600 investors in M&L realized a net profit within one year pre-petition as a result of their transactions with M&L. The Respondent sought recovery of these profits. In addition, the Respondent determined during her investigation that approximately 450 of the investors in the Ponzi scheme collectively transferred to the Debtor approximately $9.0 million within the year pre-petition and never received one penny back from the Debtor. Although Petitioner lost money overall, he did not sustain the absolute losses many investors did.

Today, as a direct result of the recovery actions she commenced, the Respondent has recovered over $15.0

million, has settlements in place which will result in additional recoveries of at least $1.0 million, and anticipates administrative expenses of approximately $2.5 to $3.0 million. At this time, allowed claims are expected to range from approximately $25.0 to $30.0 million although the claims allowance procedure has not been concluded.

The Respondent also commenced recovery actions against two financial institutions through which the Debtor operated its Ponzi scheme. Neither of these financial institutions was considered an investor, like the Petitioner, in the Ponzi scheme. The two actions against the financial institutions also were settled resulting in a recovery of over $5.0 million for the benefit of creditors of M&L, which included non-investor trade creditors.

Although many of the investors in M&L claim complete ignorance of the fraudulent nature of M&L's activities, at least one has acknowledged that he ignored his own initial intuition. The court found that he was blinded by the promise of exorbitant returns and substantial profits, and plunged headlong into the scam. *Jobin v. Lalan*, 160 B.R. 851, 858-859 (Bankr.D.Colo. 1993), *aff'd*, 167 B.R. 219 (D.Colo. 1994). At trial in this case, one witness testified on behalf of the Respondent that he declined two solicitations to invest in M&L because he believed the interest rates promised could not be real and that something had to be wrong. (Pet. App. 34).

Some investors did realize net profits which were substantial, at the expense of other investors, which is that nature of a Ponzi scheme. In *Jobin v. Ripley*, 198 B.R. 800 (D.Colo. 1996), cited by the Petitioner, (Pet. App. 9-10), the defendant realized a net profit of approximately

$78,000, and at the time M&L filed for bankruptcy, had made investments in M&L for which he was promised returns of 10% per week, or 520% annualized. The Bankruptcy Court, based on the evidence presented during a four-day trial, found the Defendant Ripley had reason to know of the fraudulent purpose of M&L, and did not act with good faith with respect to his transfers with M&L.

With respect to the Petitioner's case, the Respondent and Petitioner filed cross motions for summary judgment in the Bankruptcy Court, and on or about May 5, 1993, the Bankruptcy Court granted summary judgment in favor of the Respondent on the claims asserted under § 547(b) and § 548(a)(1). In his Motion for Summary Judgment, the Petitioner argued, without substantiation, that the Debtor's payments to him were completely protected by § 547(c)(2). The Bankruptcy Court disagreed, and found that the Petitioner had not provided any evidence whatsoever, to meet the requirements of the "ordinary course of business" exception contained in § 547(c)(2) (Pet. App. 13). Moreover, the Bankruptcy Court specifically and expressly declined to hold that the "ordinary course of business" exception does not apply, as a matter of law, to transfers in furtherance of a Ponzi scheme. Instead, the Bankruptcy Court applied the undisputed and material facts, which were presented by both Petitioner and Respondent in support of their respective motions for summary judgment, to the law under an appropriate summary judgment standard. (Pet. App. 4-13). Judgment under § 547(b) was entered in the amount of $22,000.00 in favor of the Respondent after the court allowed credit in the amount of $21,500.00 for subsequent advances under § 547(c)(4).

On appeal, the District Court declined to set aside the Bankruptcy Court's factual findings that § 547(c)(2) was not available as a defense to the Trustee's claims. The District Court found that because a determination under 11 U.S.C. § 547(c)(2) is a "peculiarly factual one", due deference should be given to the Bankruptcy Court's factual findings which were not clearly erroneous. (Pet. App. 57).

While this case was pending before the Tenth Circuit Court of Appeals and before an opinion was issued in this case on May 29, 1996, the Tenth Circuit Court of Appeals ruled in another case, unrelated but also involving a bankruptcy trustee's claims to avoid transfers to investors in another Ponzi scheme, that § 547(c)(2) is not available as a defense to investors in a Ponzi scheme. *Sender v. Hegglund Family Trust*, 48 F.3d 470 (CA10 1995). Notwithstanding its ruling in *Sender v. Hegglund Family Trust*, 48 F.3d 470 (CA10 1995), the Tenth Circuit Court of Appeals reviewed the *factual findings* of the Bankruptcy Court that the Respondent's transactions with M&L were not made according to ordinary business terms. Finding that these factual findings were not clearly erroneous, the Tenth Circuit concluded that the lower courts had properly rejected the ordinary course of business defense to the Respondent's § 547 claim. (Pet. App. 87-90). The Tenth Circuit also stated an additional reason to reject the defense, that being that the § 547(c)(2) defense is inapplicable to investors in a Ponzi scheme, citing its earlier opinion in *Sender v. Hegglund Family Trust*.

Unlike numerous other Ponzi schemes which have been operated through investment and brokerage houses,

such as the Hedged Investment scheme in *Sender v. Heglund Family Trust, supra,* the M&L Ponzi scheme promised and paid outrageous returns to the investors. In general, the promised returns in M&L ranged from 10% per month to 10% per week. In addition, M&L utilized unlicensed, and in large part, untrained brokers who received commissions on the monies they brought into M&L through additional investors. M&L utilized post-dated checks and in many instances, when checks to investors bounced, M&L and/or its brokers requested the investors to hold their checks for a number of days after the date on the check before presenting them for payment. The investors complied with these requests. *Jobin v. Lalan,* 160 B.R. 851, at 859.

With respect to the Petitioner's transactions with M&L, he invested a total of $207,500.00 in M&L from June through September, 1990. He made an initial investment of $100,000.00 on June 19, 1990, receiving post-dated checks and an unsecured promissory note offering a return of 10% per month over a two-year period. A week later, he invested an additional $7,500.00 on the same terms. Later, on September 7, 1990, and again on September 10, 1990, the Petitioner invested $50,000.00 in M&L, for a total of $100,000.00. With respect to the latter two investments, the Petitioner was promised a return of 9% per week ($4,000.00), which corresponds to 468% per annum for each of the two investments. The Petitioner received post-dated checks on all of his investments. The first check the Petitioner tried to negotiate from M&L was returned for insufficient funds (Pet. App. 33). Thereafter, the Petitioner was instructed by his broker, the long-time acquaintance who introduced him to M&L, to hold his

checks for a period of five days after the date indicated on the checks before trying to negotiate them. (Pet. App. 33). The Petitioner did as he was instructed.

The Petitioner's due diligence prior to investing in M&L consisted essentially only of the recommendation of his friend and broker, and review of a four-page document titled "1989 3rd and 4th Quarter Participation Programs". Two of the four pages of the document were cover pages, and the other two were duplicates of each other and contained no information about M&L of any value to a prospective investor. (Pet. App. 32). With respect to the § 548(a)(1) claim only, the Bankruptcy Court applied an objective standard to determine what the Petitioner knew or should have known, had he done a diligent inquiry, given all the facts and circumstances of his investments in M&L. The Circuit Court's affirmance of application of an objective standard was well-reasoned, and took into consideration the cases relied upon by the Petitioner. In rejecting the Petitioner's reliance on *Merrill v. Abbott (In re Independent Clearing House Co.)*, 77 B.R. 843, 862 (Utah 1982), the Circuit Court reasoned that a determination of good faith requires a review of evidence concerning whether the presence of any circumstances placing the transferee on inquiry as to the financial condition of the transferor may be a contributing factor in depriving the former of any claim to good faith, unless investigation actually disclosed no reason to suspect financial embarrassment. (Pet. App. 53). This inquiry must be made irrespective of the test chosen. Then, based on the evidence in the record, the Circuit Court affirmed the lower Court's factual findings with respect to the § 548(a)(1) claim only and the § 548(c) defense.

REASONS FOR DENYING THE WRIT

I. THE PETITIONER SEEKS REVIEW OF A FACTUAL FINDING THAT HE FAILED TO MEET THE REQUIREMENTS OF THE ORDINARY COURSE OF BUSINESS EXCEPTION SET FORTH IN § 547(c)(2).

Contrary to the contentions of the Petitioner, the vitality of *Cunningham v. Brown*, 265 U.S. 1, 44 S.Ct. 424, 68 L.Ed. 873 (1924) is not in question in light of the enactment of § 547(c)(2) and the rulings in this case concerning its applicability as a defense to the Respondent's preference claims. The policy of recovering preferential transfers was not undermined by the enactment of § 547(c), rather, an exception which is narrowly construed was created to encourage and preserve the terms used in normal financing relations. *Clark v. Balcor Real Estate Fin., Inc. (In re Meredith Hoffman Partners)*, 12 F.3d 1549, 1553 (10th Cir. 1993), *cert denied*, 114 S.Ct. 2677, 129 L.Ed.2d 812 (1994). There is no inconsistency between *Cunningham v. Brown* and cases decided subsequent thereto, including *Union Bank v. Wolas*, 502 U.S. 151, 112 S.Ct. 527, 116 L.Ed.2d 514 (1991). (Payments on long-term debt, as well as short-term debt, may qualify for ordinary course of business exception.)

The Tenth Circuit Court of Appeals correctly left undisturbed the factual findings of the Bankruptcy Court that the Petitioner had failed to establish any evidence to meet the requirements of § 547(c)(2) and failed to establish a defense to the Respondent's preference claim. A Petition for Writ of Certiorari is rarely granted when the asserted error consists of erroneous factual findings.

Sup.Ct.R. 10. Thus, even if it were to appear that *Union Bank, supra,* and *Cunningham, supra,* are in conflict in light of the enactment of § 547(c)(2), the Petition for Certiorari should be denied because this case can be decided on another ground, that being that factual findings by a trial court which are not clearly erroneous will be left undisturbed.

Moreover, the asserted conflict, if one indeed exists, is not sufficient reason for granting review. While the Court may decide questions of public importance, it decides them in the context of meaningful litigation. Even if the Court were to examine the issue of whether § 542(c) applies to transfers in a Ponzi scheme, the Bankruptcy Court's factual findings, which have been found not to be clearly erroneous, will preclude the successful application of the defense in this case. Thus, if the Petition for Writ of Certiorari were granted, the Petitioner would still be unable to prevail on the defense set forth in § 547(c)(2), and the review by the Court would not be meaningful.

II. IT IS PREMATURE TO GRANT CERTIORARI REVIEW OF THE APPLICATION OF AN OBJECTIVE STANDARD TO THE DEFENSE OF CLAIMS TO AVOID TRANSFERS MADE WITH ACTUAL FRAUDULENT INTENT IN THE CONTEXT OF A PONZI SCHEME.

Although other Ponzi scheme bankruptcy trustees may, in fact, rely on McKay to guide them through their administration of bankruptcy estates involving Ponzi schemes, the McKay opinion rests on the particular facts of M&L and the Petitioner's transactions with M&L. Other lower courts have not yet had the opportunity to address

these factual issues in the context of other Ponzi schemes. Although the Petitioner contends that all other Ponzi schemes are similar to the M&L Ponzi scheme, and that all investors in Ponzi schemes are innocent and were defrauded out of their savings under identical circumstances, this argument, even if it were true, misses the mark.

First, not all Ponzi schemes are alike. For example, compare the Ponzi scheme operated by Hedged Investments, Ltd., which was the subject of the litigation in *Sender v. Hegglund Family Trust, supra.* In Hedged Investments, investors were promised rates of return of approximately 15%-25% per annum at a time when the market returns were also in that range. In contrast, the M&L investors were offered, during approximately the same time frame, returns ranging from 10% per month to 9% or 10% per week. These promised returns were not realistic in the market at that time. Hedged Investments, Ltd. did not issue post-dated checks. M&L did.

Second, one of the underlying policies of the Bankruptcy Code is to promote equitable treatment among all creditors of a debtor. The Petitioner's contention that all innocent and unwary investors will be harmed by the McKay opinion ignores the fact that in the M&L Ponzi scheme, approximately 450 investors gave approximately $9.0 million to M&L within the year pre-petition and received not one penny back. The McKay opinion assures investors in M&L, as well as in other Ponzi schemes, who lost all their money, that the losses will be shared on a *pro rata* basis, with other creditors, as was intended by Congress.

Third, to grant certiorari review at this time would deprive this Court of potentially valuable discussion of the issue by lower courts. *U.S. v. Mendoza*, 464 U.S. 154, 160 (1984) (This Court benefits from "permitting several courts of appeal to explore a difficult question before this Court grants certiorari."); *E. I. Du Pont de Nemours & Co. v. Train*, 430 U.S. 112, 135 n.26 (1977) (This case "exemplifies the wisdom of allowing difficult issues to mature through full consideration by the courts of appeals."); Samuel Estreicher & John Sexton, *A Managerial Theory of the Supreme Court's Responsibilities: An Empirical Study*, 59 N.Y.U. L. Rev. 681, 715-19, n.146 (1984) (describing "affirmative value" of allowing legal issues to "percolate" in lower courts before being resolved by U.S. Supreme Court).

Last, the Petitioner's characterization of the Respondent's avoidance actions constitute nothing less than the perpetuation of a Ponzi scheme is not a contention that supports granting the Petition for Writ of Certiorari.

III. THE MCKAY DECISION DOES NOT PRESENT THIS COURT WITH AN OPPORTUNITY TO SETTLE AND RESOLVE INTERPRETATIONS OF BANKRUPTCY CODE AND STATE FRAUDULENT CONVEYANCE LAW.

The Respondent agrees that following the enactment of the Bankruptcy Code in 1978, states adopted the Uniform Fraudulent Transfer Act (U.F.T.A.), and in large part, replaced the Uniform Fraudulent Conveyance Act (U.F.C.A.). As was the case in *Scholes v. Lehman*, 56 F.3d 750 (7th Cir. 1995), in this case, the U.F.T.A. was enacted in Colorado in 1992 and does not apply to the transfers

which are the subject of the Respondent's claims against the Petitioner. However, contrary to assertions of the Petitioner, even the U.F.T.A. does not insulate "good faith" transferees from fraudulent conveyance claims. The official comment to C.R.S. § 38-8-109 (1996 Cumm. Supp. Vol. 16A) (1982 Repl. Vol.) states that an insider who receives property or an obligation from an insolvent debtor, as security for or in satisfaction of an antecedent debt of the transferor or obligor, is "not a good faith transferee or obligee if the insider has reasonable cause to believe the debtor was insolvent at the time the transfer was made or the obligation was incurred." *Id.* Thus, even the U.F.T.A. applies an objective standard to determine whether a transferee has a defense to a claim concerning a fraudulent transfer.

Although courts may vary in their general approach to the questions of good faith, there are numerous reasons for this variance, the primary one being that questions of good faith necessarily involve factual determinations on a case-by-case basis. Even the court in *In re Telesphere Communications, Inc.*, 179 B.R. 544, 557 (Bankr.D.Ill. 1994), recognized that a determination of whether a transferee acted in good faith depends on the particular facts of the case and the nature of the claims asserted. The court in *In re Telesphere Communications, Inc.* was asked to determine whether a proposed settlement of avoidance claims was in the best interests of the estate. The court first determined that there was little likelihood that Telesphere, the debtor, would succeed on the actual fraud claim asserted under § 548(a)(1). Turning to the constructive fraud claims asserted under § 548(a)(2), the court found that the transferees were likely to prevail on their good faith defense, based on the particular facts of the case. The Court found

that if the debtor was acting in good faith in seeking funding, how could the lenders have acted in bad faith in supplying it? The court found the transfers in this case were made with actual intent to hinder, delay or defraud creditors. The conclusion in *In re Telesphere Communications, Inc.* makes sense and does not dictate a need to interpret fraudulent conveyance law at the Supreme Court level. The conclusion illustrates the factually intensive nature of fraudulent conveyance litigation.

Given that most courts acknowledge any determination of good faith involves consideration of the facts of the particular case, and that courts distinguish between actual fraud and constructive fraud (claims under § 548(a)(1) v. claims under § 548(a)(2)), this case does not present an opportunity to settle widespread disagreement and to determine the proper construction of § 548(c). Contrary to the contentions of the Petitioner, courts are consistent that claims involving actual fraud, and not necessarily constructive fraud, require an inquiry into whether the transferee knew or should have known of the fraudulent intent. See *Scholes v. Lehman*, 56 F.3d 750, 759 (7th Cir. 1995) and cases cited therein for the rule that a transferee is not entitled to keep any part of the property received in a conveyance that is found to have been made with actual fraudulent intent, if the transferee knew, or should have known of the fraudulent intent. In *Scholes*, the Seventh Circuit Court of Appeals applied state law to a receiver's claims to recover property transferred in a Ponzi scheme.

Even the court in *Independent Clearing House* acknowledged the test should be one that determines if there are earmarks of an arms length bargain, i.e. an objective test, as other courts have done. (Pet. App. 84-85). Significantly,

none of the cases relied upon by the Petitioner concerns an investor in a Ponzi scheme who had notice of the kind of suspicious circumstances that surrounded M&L. See also *Hayes v. Palm Seedlings Partners-A (In re Agricultural Research & Technology Group, Inc.*, 916 F.2d 528, 536 (9th Cir. 1990). (Pet. App. 76-79).

The Petitioner's contention that there is a lack of uniformity between the Bankruptcy Code and state fraudulent conveyance laws as applied to Ponzi schemes is not supported by the law and forms no basis for granting the Petition for Writ of Certiorari.

IV. THE MCKAY OPINION IS CONSISTENT IN PRINCIPLE WITH OTHER COURTS' DECISIONS

The Petitioner's contention that the Tenth Circuit Court of Appeals' decision conflicts in principle with other decisions is based on his failure to distinguish between claims based on actual fraud versus constructive fraud. The Bankruptcy Court applied an objective standard to determine whether the Petitioner acted in good faith with respect to transfers made with actual intent to defraud. The cases upon which the Petitioner relies involved claims based on constructive fraud with respect to which the trustee was limited to recovering actual profit realized over and above the return of the investor's original undertaking. Even in this case, the Bankruptcy Court acknowledged and applied the rule that an investor involved in the Ponzi scheme holds a claim for recision and restitution of his original undertaking and that only net profits realized are subject to recovery under a trustee's claim brought under § 548(a)(2). The Petitioner's

contention does not form a basis for granting the Petition for Writ of Certiorari.

Moreover, the Tenth Circuit correctly applied an objective standard and was consistent with other courts of appeal in determinations of good faith under § 548(c). (Pet. App. 76-85). The circuit courts of appeal which have addressed defenses to claims brought under § 548(a)(2) appear to have consistently applied a subjective standard in determining whether a transferee gave reasonably equivalent value and/or had culpable knowledge of the fraud. However, those cases which have addressed defenses to claims brought for actual fraud under § 548(a)(1) have applied an objective standard to both questions of good faith and value. *Matter of Furniture Den, Inc.*, 12 B.R. 522 (Bankr.W.D.Mich. 1981); *In re Ford*, 98 B.R. 669 (Bankr.D.Vt. 1989).

While this case may involve questions that affect the public at large because it is human nature for people to be drawn to investments that promise great returns that are probably too good to be true, this Court's function is not to grant certiorari to protect investors from themselves. Courts have drawn a distinction between actual fraud and constructive fraud and correctly applied the standards to determine whether a conveyance is avoidable under the circumstances. The courts are not in conflict on these issues.

Even if the Petitioner's contention that a conflict exists is correct, the Court has had a long standing policy of letting tolerable conflicts go unaddressed until more than two courts of appeal have considered a question. Justice Brennan, Some Thoughts on the Supreme Court's Work Load, 66 Judicature 230, 233 (1933). The doctrine of

judicial restraint should be applied and the Petition for Writ of Certiorari denied.

CONCLUSION

The Respondent agrees with the Petitioner's contention that one group of investors should not bear a disproportionate share of the loss. However, in considering the importance of this case, the Petitioner would have the Court ignore the hundreds of investors in M&L who lost everything and never received a penny, and the particular facts of the M&L case. This certainly is not what the Bankruptcy Code was designed or intended to accomplish. The Bankruptcy Court, the District Court and the Tenth Circuit Court of Appeals all have correctly applied an objective standard under 11 U.S.C. § 548(c) with respect to the claim under § 548(a)(1), and correctly denied the defense set forth in 11 U.S.C. § 547(c)(2) of the Bankruptcy Code. The Petition for Writ of Certiorari should be denied.

DATED this 12th day of November, 1996.

Respectfully submitted

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